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Japan's Recession Accompanied By Payments Turnaround

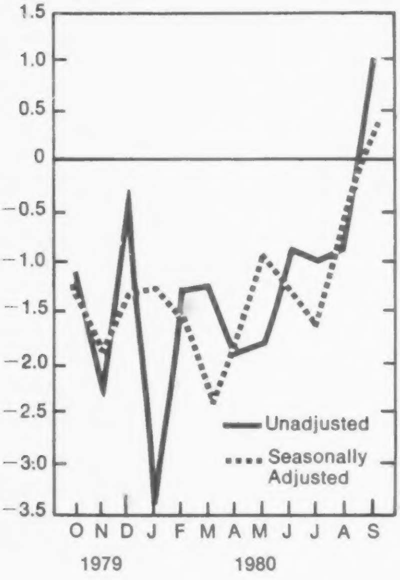
The Japanese economy is now experiencing a period of extremely slow growth—a recession, Japanese-style. Domestic demand has been virtually flat since the beginning of the year, with private consumption the major element of weakness. In addition, the housing industry has been in recession, and public-sector spending declined in real terms in the January-June period as the government sought to bring its fiscal deficit under control. The only bright spots have been exports and private investment demand. Net exports, for example, accounted for nearly 90% of the increase in real output during the first two quarters of 1980.

Despite the recent relaxation of monetary policy, current evidence suggests relatively little output growth during the next two quarters. Most of last summer's rise in producers' inventories remains to be worked off. Residential construction is likely to remain weak. And export growth is slowing in volume terms. Countering these tendencies will be some continued strength in private investment in plant and equipment—which seems more oriented to modernization and energy conservation than to capacity expansion—a temporary acceleration in public-works expenditures, and a modest recovery in the growth of personal consumption as the rate of consumer price inflation falls below the growth of personal disposable income.

Partly because of this growth slowdown, Japan's balance of payments has made a remarkable turnaround. Since the first quarter of the year, the trade balance has shifted from significant deficit to comfortable surplus. In the process, the huge deficit on current account has largely been eliminated. Indeed, the recent data on licensed exports and approved imports suggest that the fourth-quarter trade surplus (unadjusted for seasonal variation) may be large enough to bring the fourth-quarter current account close to balance.

The balance-of-payments outlook for 1981 is clouded by uncertainties as to the price of oil and political resistance in Europe and the United States to the continued growth of Japanese exports. But two positive factors should be kept in mind. First, much of the recent reduction in imports reflects the success of oil conservation measures—and, hence, is permanent. Second, if the yen continues to strengthen, dollar-based Japanese export prices are likely to increase fairly rapidly. Thus, even if export volume should prove sluggish, the dollar value of Japanese exports could show healthy growth for some time.

The Japanese
current-account balance
(monthly, $ billion)



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Austrian economy weakens in response to slowdowns abroad.

After a strong first half, the Austrian economy is beginning to soften in the face of the European—and especially German—recession. Industrial production appears to have peaked around midyear, with the July index just 1.2% above its year-earlier level. Inflation has also eased somewhat; the year-over-year rate in September was 6.9%, versus 7.3% in August. And the January-August current-account deficit was 28 billion schillings, compared with 10.4 billion schillings in the similar period in 1979, confirming forecasts of a 42-billion schilling deficit for all of 1980. Finance Minister Androsch's 1981 budget proposals call for mild fiscal tightening to narrow the payments gap. But the more significant influences on Austria's external accounts and overall economic performance will be the strength and duration of Germany's recession and the timing of a significant easing of German monetary policy.

Finnish economy will record highest European growth rate this year.

Finland's economy continues in high gear and should see real GDP growth of more than 6% this year, the highest in Europe. The economy, however, is showing signs of strain. Unemployment has fallen and many sectors have reached full capacity. Furthermore, inflation has accelerated to break the 11% level, and the balance of trade has deteriorated. A 5.1-billion markkaa deficit was recorded for the first nine months of the year, compared with a 50-million markkaa surplus for the same period in 1979. In response, the four-party coalition government has agreed to a mildly restrictive budget involving an 11% indexation of income tax scales and holding total government expenditures to about 56 billion markkaa, compared with the 43 billion markkaa spent in 1979.

Mexican economic activity slows from feverish to brisk.

Mexican economic activity continues brisk, but the pace of growth has slowed from last year. Industrial production through May was 6.5% above the year-earlier level, which represents a large decline from the almost 11% increase between 1978 and 1979. (Manufacturing, for example, is up only 3%-5% this year, although the oil sector is expanding at rates approximating 20%.) Slowdown is evident on other fronts. Retail sales were up only 3% in real terms in the first half, versus nearly 14% in 1979, and construction is also slightly below the first-half 1979 pace. Largely responsible for the apparent slowdown are the resultant strains and bottlenecks in many sectors as demand outstrips domestic supply. Such constraints raised imports in the first eight months of 1980 by 56% and pushed the rise in wholesale prices to 26% in August. These influences, together with anticipated weakness in agricultural output, point to a real GDP growth rate of 7% in 1980, below last year's 8%, and with higher inflation.

New Zealand's trade surplus is narrowing.

New Zealand's trade surplus for the 12 months ended August declined to $766 million from $794 million in the year-earlier period. A 16.8% rise in export receipts, mostly for wool and dairy and forest products, was eclipsed by a 21.1% increase in import payments, related mainly to more costly oil and refined products. Export prospects for the next 12 months are mixed. Although wool and dairy product prices are likely to decline, export prices for beef and lamb are expected to rise. However, sales of lamb to Iran and Iraq may not materialize because of the continuing Middle East conflict. The recent agreements with the EEC on butter and sheepmeat cut the volume of such exports, but may result in increased revenue for farmers because EEC tariffs have also been reduced. Finally, the monetary authorities have been allowing the NZ dollar to fall steadily against a trade-weighted currency basket, and, if continued, this should help maintain export competitiveness.

New Turkish government continues policy of austerity.

Turkey's new military government has vowed to maintain the austere economic policies of the previous government. To this end, the chief economic strategist of the former government, Turgut Ozal, has been retained. Results of the new policies instituted early this year are mixed. The rate of increase in wholesale prices has eased more quickly than expected. Monthly rates are now less than 3%, bringing the year-over-year wholesale price inflation rate down from 133% in February to 100% in August. Export earnings, however, rose only 7.7% in dollar terms in the first half, and workers' remittances—a major source of foreign-exchange—are actually running below 1979 levels. Imports in dollar terms rose by 17% during the same period, well below earlier official forecasts, probably reflecting problems in obtaining foreign financing. With greater amounts of external finance available in the second half of 1980, imports since June are likely to accelerate. And even with continued economic austerity, Turkey will still need at least $3 billion in new foreign capital next year.

Hong Kong economic growth will be unusually brisk in 1980.

It now appears that Hong Kong will achieve 10% real GDP growth in 1980, a remarkable feat for an export-oriented economy whose major trading partners are experiencing varying degrees of economic recession. The leading sectors have been financial and entrepot services, where rapid growth has been largely fueled by China's modernization drive. The faster growth has stimulated imports, which will cause the trade gap to expand to about $3 billion this year and which has already put considerable pressure on the HK dollar exchange rate. The higher prices for imports are largely responsible for the current 15% rate of inflation. The outlook is for a continuation of double-digit economic growth into 1981 but with some relief possible for inflation. The HK dollar is expected to exhibit greater strength next year owing to heavier capital inflows and an improved trade balance. Consequently, the rate of inflation in 1981 is expected to fall below 10%.

Egyptian external accounts show marked improvement.

Egypt's external-account performance has improved substantially since 1978. In that year, Egypt recorded a current-account shortfall of $1.2 billion and an overall payments deficit of $1.1 billion. The latter was financed by foreign aid, including official grants and loans from Arab and Western governments. In 1979, exports of goods and services rose by 21½% to $6.6 billion, led by petroleum earnings and an increase in workers' remittances. Nevertheless, imports of goods and services expanded at a faster 22% pace to $8.2 billion, widening the 1979 current-account gap to $1.6 billion. The overall balance of payments, however, showed a marked turnaround last year, posting a surplus of $28 million, despite a sharp decline in financial aid from Arab governments. The improvement can be traced to a marked expansion in the inflow of foreign direct investment, as well as to foreign aid commitments from Western governments and institutions totaling $2 billion. Egypt's external accounts will show further substantial improvement in 1980 for two reasons. First, the country's trade deficit will probably narrow somewhat, given the strong likelihood of an expansion in all categories of Egypt's principal exports of goods and services. Second, aid commitments from the West have risen to about $2.5 billion, and the rate of disbursement appears to have picked up. As a result of these developments, international reserves have risen steadily since the end of 1979, reaching a record $1 billion as of mid-1980.

Sugar prices seen holding high as stocks are drawn down.

Sugar prices appear likely to sustain their current strength over coming months. Although early projections of 1980-81 production suggest some increase in output, the outlook remains clouded. And this does little to ease the speculative forces that have in recent months pushed sugar prices to their highest level in five years. In October, the International Sugar Agreement world price for raw sugar averaged more than 40¢ per pound—about double the price last February. With the 1979-80 growing season hurt by uneven weather, strikes, and disease-plagued cane fields, sugar production fell to 85.4 million metric tons—down 5½% from output in the previous year. At the same time, sugar consumption continued its strong and steady rise, totaling 91 million tons last season and necessitating a worldwide stock drawdown of some 5.6 million tons. Although current high prices may work to moderate consumption, additional reductions in stocks over the coming year are still anticipated. In the past, high sugar prices have coaxed increased production, sometimes causing the market to overreact and produce a worldwide glut, which in turn sent prices plummeting. This year, high oil prices have made ethanol production an attractive alternative for some sugar cane growers. Consequently, it is unclear how high sugar prices must rise to shift output back to production for human consumption.

State and Local Governments Expand Debt

Over the last year and a half, state and local governments have been going deeper and deeper into debt. On a national-income-accounts basis, the operating budgets of state and local governments have accumulated about $22 billion of deficits since early 1979. And heavy borrowings are coming at a time when interest rates on municipal issues are at record levels.

In some respects, the pattern is a replay of what occurred in the 1973-75 recession. A softening of economic activity caused tax receipts to slow or fall, especially revenues from personal and corporate income taxes and sales taxes. And the federal government cut back on its grants to state and local governments. At the same time, rising unemployment kept pressure on local spending for job programs and transfer payments. The result was that deficits mounted.

Even in good times, state and local governments must borrow. Their income flow, much like a household or business, is seasonally uneven (depending on tax dates, for example). Consequently, they must borrow short term to ensure a more uniform cash flow that matches their steadier pattern of expenditures. And they borrow long term to finance capital construction or durable equipment purchases, or to refinance existing debt.

In 1977, state and local governments had gross new debt issues of $71.5 billion. As the recovery continued, borrowing fell to $69.7 billion in 1978 and to an annual rate of less than $60 billion in the first quarter of 1979. But the shift into a deficit position helped push borrowing to an annual rate of about $67 billion for the remainder of 1979. New debt issues have surged to an annual rate of $78 billion during the first eight months of 1980, with some $7 billion of this representing borrowing to bolster the mortgage market.

Although the economic slump has led some state and local governments to borrow larger sums, they still seek to minimize the cost of borrowing, especially in the bond markets where there is more discretion as to timing. When municipal bond rates soared to their then-record levels in the first quarter of 1980, the pace of long-term borrowings slowed to about 75% of the pace in the first quarter of 1979. But as bond rates plunged in the spring, long-term borrowings jumped 40% above their year-earlier level. Municipal bond rates have now risen above last winter's peaks, and state and local governments have shifted more toward short-term borrowing. But rapidly rising short-term interest rates since the summer have made this choice costly as well.

Unless spending growth can be substantially trimmed, or unless Congress limits mortgage-related borrowings, the prospect is for continuing deficits and increased borrowing in 1981. A sluggish economic recovery offers little hope of any fundamental improvement in the outlook for tax receipts. And pressures on the federal deficit preclude much, if any, added assistance coming from Washington.

New Reserve Rules Complicate Fed Policy

The phase-in of bank reserve-requirement changes beginning this month should make it more difficult for the Federal Reserve to manage reserves in a manner consistent with its monetary objectives in the near term. It should also make it more difficult for money-market participants to interpret the significance of open market operations and of reserves statistics in coming weeks.

In keeping with the provisions of the Monetary Control Act of 1980, new reserve requirements are being phased in this month. Beginning with the week ending November 19, some commercial banks and thrift institutions that are not members of the Federal Reserve System will be required to hold reserves against certain deposit balances that were on their books two weeks earlier. The reserve-requirement schedules for member banks will also change, with reserve requirements falling, on balance.

One stated purpose of this Act is to enhance the ability of the Federal Reserve to control the money supply by extending reserve requirements on deposits to all depository institutions. These reserve-requirement changes will be phased in over an eight-year period. However, the phase-in process initially complicates the implementation of monetary policy.

The reserve-requirement changes will cause significant movements in the weekly reserves measures. Total required reserves are estimated to fall by about $3 billion, while excess reserves at nonmember institutions are expected to jump by more than $3 billion. (The reason for the latter estimate is that many of the smaller of these institutions hold substantial amounts of vault cash that will exceed their initial reserve requirements.)

Such estimates, however, are subject to significant uncertainty. Consequently, interpreting the motivation for open market operations—i.e., Fed transactions in U.S. securities that affect reserves—in the coming weeks will be more difficult than recently.

Moreover, estimates of these measures will continue subject to greater uncertainty in future weeks. This is especially true for the excess-reserves measure, since there is little evidence of how the demand for excess reserves of nonmember institutions fluctuates over time, or how sensitive it is to interest-rate changes.

Consequently, the Federal Reserve's task of estimating a target for nonborrowed reserves (required plus excess reserves less bank borrowings from the Fed discount window) that is consistent with its monetary growth objectives will be more difficult than usual in coming weeks. This increases the likelihood that the Fed may focus more on the behavior of the federal funds rate in conducting monetary policy in the near term. This would not mean, of course, that the funds rate will be stable. It would imply, however, that open market operations would be designed to a greater extent to limit fluctuations in the funds rate arising from unanticipated shifts in the demand for reserves.

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1978		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				exchange rate in U.S. dollars	change from year earlier		
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer •prices	latest data	money supply(M_1)	November 5, 1980		current monetary conditions	
Algeria	Development plan for 1980-84 to be approved later this year; investment target set at $104 billion.	June	+ 59%	24.6	$ 1,374	Sept.	3,798	+ 52%	5.6	0	U.S. and Algeria fail to agree on El Paso LNG import price.	June '79	+ 14%	Dec.	+ 15%	.2640	+ 1%	Credit generally available.	**Algeria**
Cameroon	Budget for fiscal 1980/81 includes substantially higher levels of investment spending.	Mar.	+ 67%	4.0	500	May	199	+ 91%	1.7	18	Sharp rise in oil output boosts trade account.	June	+ 12%	Apr.	+ 27%	.00465	− 3%	Rapidly rising foreign-exchange reserves enhance liquidity.	**Cameroon**
Egypt	Economic reforms planned for public sector, customs service, tax law, and foreign investment.	June	+ 74%	16.4*	400	July	1,079	+221%	3.0	249	Oil output averaging 600,000 bpd, up 14% from 1979.	June	+ 25%	June	+ 17%	1.4300	0	Money supply expanding rapidly.	**Egypt**
Gambia	Smallest groundnut crop in 12 years triggers 19% drop in FY 1979/80 real GDP.	July	− 41%	0.1	182	Sept.	10	+182%	0.3	9	Sharply higher trade deficit reflects one-third higher import costs.	July	+ 4%	June	− 3%	.6150	+15%	Money supply contracts.	**Gambia**
Ivory Coast	Poor rains expected to reduce 1980/81 cocoa crop 8% below last year's 360,000-ton bumper.	Jan.	0	7.6	1,440	June	23	− 91%	0.1	0	Domestic oil output could save an estimated 30% of 1981 oil costs.	July	+ 10%	Mar.	+ 3%	.00465	− 3%	IMF-backed austerity program restricts liquidity.	**Ivory Coast**
Kenya	High oil import costs curtail supply of development funds; business remains pessimistic.	Apr.	+ 39%	6.0*	400	Sept.	452	− 26%	2.6	135	Sagging tea and coffee prices and weak tourism restrict fx earnings.	Aug.	+ 14%	May	+ 18%	.1400	+ 5%	Interest rates rise to stimulate savings.	**Kenya**
Morocco	September reduction of subsidies for basic food commodities aimed at reducing budget deficit.	Mar.	+ 52%	15.3*	788	Aug.	166	− 65%	0.9	165	Price of phosphate rock exports resumed upward trend in August.	June	+ 10%	June	+ 16%	.2470	− 5%	IMF approves three-year credit facility for SDR 810 million.	**Morocco**
Nigeria	Apart from buoyant oil sector, economic performance is disappointing.	June	+ 70%	50.7*	625	Aug.	9,249	+127%	9.5	0	Recent cutbacks suggest oil output of 1.95 million barrels daily in 1980.	Dec.	+ 12%	May	+ 17%	1.9380	+12%	Foreign-exchange inflows expand liquidity.	**Nigeria**
South Africa	Acceleration in economic activity has yet to produce signs of overheating.	July	+ 45%	57.3*	2,070	Sept.	1,225	+ 50%	0.8	0	This year's $4-billion current-account surplus likely to evaporate in 1981.	Aug.	+ 12%	June	+ 27%	1.3330	+10%	Liquidity continues excessive.	**South Africa**
Tanzania	Rise in producer prices should boost 1981/82 food output.	Dec.	+ 9%	4.6*	267	Aug.	48	− 25%	0.5	10	Poor export outlook threatens to widen last year's $575-million trade gap.	Mar.	+ 21%	Dec.	+ 51%	.1229	+ 2%	IMF makes $255 million available over two-year period.	**Tanzania**
Zambia	Production problems cut copper output 28% to 506,000 tons for year to June.	Nov. '79	+ 22%	3.2*	572	Aug.	65	− 17%	1.3	445	Weak markets for copper and cobalt reduce foreign-exchange earnings.	Mar.	+ 11%	June	+ 19%	1.32[illegible]0	+ 6%	Increase in liabilities widens net foreign asset gap.	**Zambia**
Zaire	Economic contraction reported to be arrested; rate of inflation slows.	Dec.	+279%	6.4	230	Aug.	178	− 15%	3.3	271	Rescheduled debt payments being met; further rescheduling set for 1981.	June	+ 50%	Apr.	+ 19%	.3530	−28%	Business loans show substantial rise.	**Zaire**
Tunisia	Industrial output expansion slows from 1979 pace.	Mar.	+ 53%	7.0*	1,096	Sept.	709	+ 43%	3.1	0	Phosphate output in first half was 2.4 million tons, 51% above year earlier.	July	+ 10%	May	+ 10%	2.5100	+ 1%	Saudi/Tunisian investment company to be set up.	**Tunisia**
Jordan	Japan's Overseas Economic Cooperation Fund lends $40 million for telephone network.	Mar.	+ 37%	2.8*	917	Sept.	1,231	+ 10%	7.1	0	Phosphate exports through August up 41% from year-earlier period.	July	+ 14%	June	+ 28%	3.3800	+ 2%	Euroloan of $150 million signed in late September.	**Jordan**
Kuwait	New five-year plan beginning 1981/82 includes development-project allocation of $11.2 billion.	June	+ 5%	23.3**	18,330	Sept.	3,302†	+ 25%	7.8	0	Oil export boost of 350-400,000 bpd planned for fourth quarter.	Dec.	+ 6%	June	+ 28%‡	3.7106	+ 3%	Rising dollar rates and Gulf War spur heavier capital outflow.	**Kuwait**
Qatar	Imported food prices in state-controlled shops to be heavily subsidized.	June	+ 53%	4.5	22,500	Mar.	328†	n.a.	3.3	0	Rise in crude oil exports of 20,000 bpd reported.	n.a.	—	Mar.	+ 24%‡	.2748	+ 3%	Bank credit to private sector rising steadily.	**Qatar**
Saudi Arabia	Several contracts awarded for projects in petrochemicals, infrastructure, and desalination.	June	+ 94%	74.8	11,510	Sept.	23,896†	+ 35%	9.0	0	Oil output reportedly 10 million bpd, vs. 10.4 million in first-half October.	Mar.	+ 2%	May	+ 48%‡	.3011	+ 1%	Money supply rising rapidly.	**Saudi Arabia**
United Arab Emirates	Private-sector economic activity continues to expand steadily.	June	+ 58%	13.8	19,435	Sept.	2,230†	+128%	3.8	0	Abu Dhabi oil export price raised $2 per barrel.	n.a.	—	June	+ 1%	.2711	+ 3%	UAE cabinet to set up a specialized real estate bank.	**United Arab Emirates**

*1979 **FY 1979/80 †Excluding state reserves ‡Private sector only

World Interest Rates

market rates of Nov. 5, 1980; bond yields as of Oct. 31, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	12.16	16.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.00	7.25
Day-to-Day Money	15.00 Nov. 6	11.50	15.50	12.00	19.75	9.10	17.75	9.00	5.25	10.8125
Treasury Bills 91-day, Middle Rates	13.44	12.55	14.625	12.10	n. a.	n. a.	15.699 87-day	no dealing	no market	6.375 2-month
Commercial Paper prime, 3-month, asked	13.25 finance paper	12.60 finance paper 15% tax w/h	14.4385	11.60 Certified	11.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.20	12.50 15% tax w/h	15.75	11.60 Certified	not traded	9.90	n. a.	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	12.11	13.25	12.92	10.61 20% tax w/h	13.435	8.57	21.35	10.32	4.69	8.452
Industrial Bonds prime, long-term, new and old issues, average yield	12.95 Aa Industrials	13.875	13.61	14.774	14.57	8.73	16.06	10.24	5.784	7.20
Bank Short-Term Rate to Best Borrowers (prime rate)	15.50 Nov. 6	13.25	17.50	15.75	13.85	11.50	16.23 ⅛ qtrly. fee on outstdng.	11.00	5.50	8.50
Bank Time Deposits 3-month	14.625 Cert. of Dep.	n. a.	16.50	12.25	11.375	9.20	21.00	9.375 large deposits	5.25 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	15.9375	no market	17.25	no market	11.50	9.25	no market	9.375	5.375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8590	2.4460	.03216	.2238	.5152	.001197	.4770	.5745	.004743
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	3.625 *P*	1.00 *D*	3.50 *P*	4.50 *P*	6.625 *P*	9.625 *D*	6.375 *P*	10.375 *P*	5.75 *P*

Eurodollar Deposits
(London, interbank, bid)
Nov. 5

7-day	14.50
1-month	14.4375
3-month	15.8125
6-month	15.6875

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	+ .016
U.S.-Canada Treasury Bills	−2.17
U.S.-Canada Finance Co. Paper	−2.80
Eurodollars-U.K. Local Auth. Deposits	+ .9375

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.375
Over 7 yrs.	13.50
DM Bonds	
7 yrs. and under	6.375
Over 7 yrs.	6.50

Gold Price
London
afternoon fixing
652.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Maturity Distribution of Chinese Commercial Debt

(million $)

	End-1977	Mid-1978	End-1978	Mid-1979	End-1979
Claims on BIS Banks	2,481	3,177	2,440	3,538	2,662
Liabilities to BIS Banks	455	891	992	3,141	2,456
Up to 1 year	390	647	780	2,695	1,292
1-2 years	7	11	5	7	37
More than 2 years	55	35	26	289	961
Unallocated	3	198	181	150	166
Undisbursed Credit Commitments	449	520	1,224	2,642	3,839

Source: Bank for International Settlements

China Streamlines its Development Strategy

China's recent National People's Congress, which concluded in September, marked a political and economic turning point. The resignation of Hua Guofeng and Deng Xiaoping from their government positions and the promotion to prime minister of a younger technocrat, Zhao Ziyang, set a precedent for peaceful succession and future political stability. On the economic front, the Congress explicitly abandoned the ambitious ten-year development plan unveiled in March 1978 and underscored the more gradual, but balanced, economic strategy of the past year.

The more conservative approach to economic development was introduced in 1979 with a three-year plan of "readjustment and consolidation" for the 1979-81 period. The new strategy shifts priority from heavy industry to light industry, agriculture, electric power generation, and transportation. The new realism acknowledges the limits on China's absorptive capacity—its technical and managerial expertise as well as its basic infrastructure—and seeks to generate needed foreign exchange over the nearer term.

Given political stability and more realistic growth targets, China should achieve average annual national income growth of 5%-6% between 1980 and 1985. The country's basic advantages include plentiful supplies of energy and raw materials, a large and motivated work force, and sufficient financial resources. The average growth rate for industrial production during the 1980-85 period is expected to be 7%-8%, somewhat lower than it would have been under the earlier ten-year plan. After the remarkable gains of 1978-79, agricultural growth will probably average only about 2½%, but foreign trade volume through 1985 could expand by 7%-9%, on an average annual basis. Imports, which should climb rapidly for several more years, will consist mainly of grain and capital equipment, while export growth will be stimulated by increased volumes of light manufactures and higher world energy prices. Oil export prospects have been revised downward, given current limits on production and delays expected in developing offshore reserves.

China's economic growth prospects for the 1980s have been strengthened in recent years by several important organizational developments. A tilt toward economic pragmatism has been indicated by the government's efforts to foster freer markets and greater enterprise autonomy. Following the experiments introduced in Sichuan by Zhao Ziyang, state-owned enterprises have been given more decisionmaking authority and permitted to retain a portion of their profits. In addition, orthodox banking practices are being restored—with more economic transactions being shifted from budgetary to financial channels—and the Chinese legal framework has developed rapidly to accommodate commercial contracts and joint ventures with foreign firms. The authorities have also acknowledged the critical need to enhance the quality of management techniques to accompany the gradual decentralization of economic activity. To improve economic planning and macroeconomic policy in the 1980s, improvements are needed in collecting and processing economic information. For the first time since 1959, comprehensive data for the 1977-80 period have been published by the State Statistical Bureau.

Recent economic performance

Reflecting the leadership's new policies, the rate of growth of China's heavy industry slowed markedly in 1979 from the more feverish pace of 1977-78. Total capital investment grew only 4.4% in 1979, after having increased 31.3% the year before. Agricultural output rose sharply in 1978 and 1979, with a record grain harvest of 332 million metric tons and a 24% increase in meat production in 1979.

China's total exports reached $13.7 billion last year, up 37% from 1978. The strong export showing was the result of the sharp rise in oil and basic commodity prices, as well as buoyant demand for Chinese manufactured goods (including textiles, handicrafts, and food). The value of imports (f.o.b.), however, rose even more sharply to $14.5 billion, up 41% over 1978, owing to record imports of grain (despite the good harvest), steel, and machinery. Thus, a global trade deficit of less than $1 billion is estimated for 1979. Trade with other Communist countries rose much less rapidly in 1979 and may have actually declined in real terms. Overall, real national income is estimated to have grown 7%, a steep deceleration from the 12% rise posted in 1978.

Recently, industrial performance has turned up once again. In the final quarter of 1979 through the first half of 1980, industrial growth surged. The upturn has been concentrated in light industry, textiles, chemical fertilizers, and electricity generation. Stimulated by the strong harvest of 1979 and by decentralization, output of light industry and of textiles grew 24.4% and 28.8%, respectively, above first-half 1978. Electric power generation grew nearly 10% above 1979 levels, with faster growth in hydroelectric power and improved performance in coal-powered generation. The rise in chemical-fertilizer production —22.6% higher than first-half 1978 output—was partly the result of the completion of new phosphate plants. On the agricultural front, the 1980 harvest is unlikely to repeat last year's record showing; a drought in the northeastern region is expected to trim the wheat harvest by more than 6% and reduce output of several other crops. Overall, Chinese national income is pro-

China Streamlines its Development Strategy

(continued from page 7)

jected to grow 6.5% during 1980.

China's trade deficit is expected to increase slightly to around $1.5 billion in 1980. Windfall gains from world oil prices in the first half have boosted export earnings sharply. (Some eight million tons of crude are expected to be exported to Japan this year; the average per-barrel price paid by the Japanese in the first half was $33.) Export volumes of hard coal and coking coal, also mainly to Japan, have climbed more steeply. In contrast, Chinese imports of machinery and steel products in the first half rose only by 10%-15%, and grain imports are projected to exceed 12 million metric tons for the 1980/81 marketing year, an increase of 20% from the previous year. In October, a four-year U.S.-China grain agreement was signed. This assures the Chinese 6-9 million tons of U.S. grain annually and supplements earlier long-term agreements signed with Canada, Argentina, and France.

China has also moved quickly to obtain Western and Japanese technology. Even where no equipment exports are involved, foreign firms are paid for engineering design, licenses for technology, and training of personnel. The wooing of foreign technology has gained in importance over the past year. The 1979 collapse of a domestically produced offshore oil rig in the Bohai Gulf underscored bureaucratic malfeasance and indicated that Western technology was essential for offshore petroleum development. In addition, the Baoshan metallurgical complex, a key project of the earlier 10-year plan involving heavy import content, is already a disappointment. Problems here have been attributed to Chinese planning failures, however, and not to any deficiencies in imported technology and equipment.

Although China's petroleum industry will record near-zero output growth this year, it holds the greatest promise for reasonable balance of the country's external accounts when offshore reserves are brought into production later in the decade. Petroleum will also be the lynchpin of China's developing relations with both Japan and the United States. China has contracted with Japanese, U.S., and British firms for offshore exploratory drilling and has invited bids from Western firms to develop offshore oil and gas reserves. Agreements have been signed with Japanese and French concerns to exploit reserves in the Bohai and Beibu Gulfs, under joint-investment and risk-sharing arrangements. And American oil firms are expected to assume a major role in developing the oil potential of South China Sea fields. Output from existing onshore fields is expected to begin declining by 1982, which lends some urgency to the development of offshore fields.

External debt will rise, but cautiously

China has had little problem in obtaining plentiful supplies of external credit, largely because of its sound financial condition and low external debt level. At the beginning of 1980, gross external debt was around $4 billion, hard currency reserves exceeded $2.5 billion, with gold reserves estimated at 500 tons. The Bank of China has sought to supplement its resources with short-term commercial credits, long-term official (export) credits, and development loans from the United Nations and Japan. During 1979, China's external liabilities to commercial banks rose nearly $1.5 billion, roughly two-thirds of which was in the form of medium and long-term credits. At the same time, undisbursed credit commitments grew by $2.6 billion (see bottom page 6).

China's borrowing strategy is aimed at maintaining financial flexibility as external obligations rise during the current decade. It now appears, however, that further rises in external indebtedness will be more gradual than abrupt. More recently, the Chinese have been reluctant to borrow in Western capital markets with nominal interest rates so high. As China's absorptive capacity increases, the net capital flow from abroad might reach the $3-$4-billion level long hoped for by Japanese and Western business. China's IMF quota was recently raised to SDR 1.2 billion, and most observers expect the new member to play an active role in both the IMF and the World Bank.

A rapid expansion in China's economic relations with the West depends upon many factors. The first and foremost is China's political stability and its commitment to economic cooperation with other nations, conditions that have generally been met since the death of Mao Zedong. Indeed, there appears to be a general consensus among Western observers that political stability has increased significantly in recent years. Consequently, the announced priorities of economic growth and modernization have a more secure political foundation than in any other period since the 1950s. Macroeconomic performance and the standard of living have shown clear improvement, which has boosted worker productivity and morale. And the recent revision of economic priorities should sustain domestic financial equilibrium. Political controls, however, have tightened and may be strengthened further to sustain political stability.

In sum, China's long-run growth prospects are impressive, largely because of fundamental internal economic and structural advances. Moreover, these domestic developments have been reinforced by international events that have worked to China's advantage, such as the OPEC oil price shock of 1979-80 and the Soviet invasion of Afghanistan.

Donald W. Green

ERRATA — Page 6

Correct Italian interest rates are as follows:

Bankers' Acceptances	21.35%
Government Bonds	16.06%
Industrial Bonds	16.23%
Bank Short-Term Rate	21.00% ⅛ qtrly. fee on outstdng.
Bank Time Deposits	10.75%

Correct French interest rate is as follows:

Day-to-Day Money	10.75%

CHASE

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Europe's Restrictive Policies Dampen Prospects for Recovery

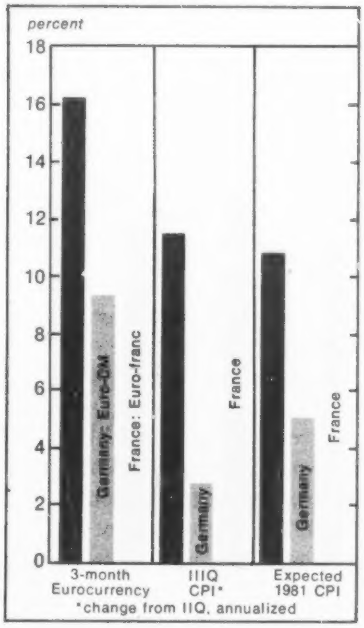
Evidence of economic slowdown throughout Europe is now well established. Industrial production in the United Kingdom began its decline in the third quarter of 1979; it now stands 8% below its second-quarter 1979 peak. German industrial production peaked in the first quarter of 1980 and has been declining ever since. And data suggest that Italy and France entered recessions in the second quarter of 1980.

The continent-wide slowdown has been accompanied by a generalized easing of inflationary pressures. The rate of consumer price inflation has been running in the 5%-6% range in Germany. In the United Kingdom, the annualized monthly rates for July, August, and September were in the 10% area, and French inflation has stabilized in the low double digits. These improvements, however, have brought little relief for the currently high level of European interest rates. Short-term money market rates in Germany are 3-4 percentage points above the current inflation rate and the expected rate for 1981. In the United Kingdom, current short-term rates of 16% provide significant expected real returns, with the 1981 inflation rate likely to be only 10%-12%. In Italy and France, the degree of monetary stringency is less apparent in terms of expected real yields, but both the lira and the franc have been strong against the German mark in the European Monetary System, suggesting that their policies have been at least as restrictive as those in Germany.

The recent behavior of the European monetary aggregates further illustrates the degree of monetary tightness now prevailing in Europe. Germany's narrowly defined money supply, M_1, is less than 3% above its year-ago level. Similarly, M_1 in the United Kingdom has grown by less than 5% in the last year, and French M_1, by 7%. (Broader monetary aggregates have grown much faster, but these include some money market instruments that bear interest at competitive levels. Such instruments are chosen by investors over bonds when restrictive monetary policy produces an inverted yield curve, and are consequently less useful indicators of the tenor of monetary policy.)

The surprisingly restrictive nature of European monetary policy is in no small way the result of a similar policy being pursued in the United States. Still, the consequences for economic growth will not be avoided, and European recovery in 1981 stands to be very sluggish. Even if the currently restrictive monetary policies are eased by spring, it will be difficult for Western Europe to achieve a combined real economic growth rate of more than 1.5% in 1981.

Selected European inflation and interest rates



*change from IIQ, annualized

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Market anticipates further U.K. interest rate cuts soon.

Ever since the 1% cut in the United Kingdom's minimum bank lending rate in July 1979, the market has anticipated further rate declines in the face of a deepening domestic recession. The slowdown has certainly worsened—September industrial production was down $9.3% from its year-earlier level and the volume of retail sales had fallen to its 1972 level—but the money supply has continued to surge; sterling M_3 in October stood 18.1% above its October 1979 level. Since the authorities have given priority to limiting monetary growth to 11% per annum, they have been unwilling to reduce interest rates until a more favorable money growth trend is seen. But as the recession deepens, the government will come under increasing pressure to lower interest rates; and this has led to the market's expectation of an early rate reduction. Meanwhile, the large interest-rate differential favoring sterling has kept the currency strong, boosting its trade-weighted index (1971=100) to a peak of 80.2, the highest level since April 1975.

New Belgian coalition government also committed to fiscal restraint.

Belgium's 1981 budget, originally announced in August, contained proposals to raise indirect taxes and reduce social security expenditures by 15 billion francs, helping cut the public-sector borrowing requirement to 242 billion francs next year from BF 254 billion in 1980. The proposals to reduce social security spending ran into parliamentary difficulties and were the proximate cause of the downfall of Wilfred Martens' third coalition. The new coalition government of Mr. Martens still envisages a deflationary budget, with provisions for wage restraint in the private sector supported by legislation, a reduction in government officials' salaries, a cut in social security outlays, and a job protection program supported by tax incentives and grants to small and medium-sized companies. Although no figures on the magnitude of the expenditure cuts have yet been released, public investment is expected to decline in real terms. Official forecasts, however, still expect a small increase in real GDP in both 1980 and 1981.

Portugal awaits presidential election with weakening economy.

The general election win of Sa Carneiro's center-right democratic alliance represents one step toward the political stability that Portugal needs for its long-term economic health. The presidential election set for December 7, however, will be equally significant. If the incumbent General Eanes is reelected, the government could have problems implementing its program of economic liberalization. In the interim, the authorities must continue grappling with a rising oil bill, high inflation, and depressed world markets. The current-account for the period January through May 1980 was in deficit by $600 million—compared with a gap of $34 million for all of 1979—even with a strong tourist season and large inflows of workers' remittances. A deficit of $800 million for the full year appears likely. Domestic inflation subsided to a year-over-year rate of 16% in August, down from 23% in March, following the escudo's revaluation. But rapid monetary growth and the likelihood of reflationary policies are expected to return the inflation rate to more than 20% in early 1981.

Malaysian economy hurt little by worldwide recession.

The Malaysian economy has been little touched by the worldwide recession. Real GDP growth this year is projected at 8%, roughly the same as in 1979. Although the consumer price inflation rate will climb from last year's 3.6%, the rate should not exceed 7%-8%. On the external front, the current-account balance is expected to show a small surplus after posting a surplus of almost $1.4 billion last year. Export volume is off slightly in rubber and tin, but palm oil exports have risen sharply. Oil production will be down to an average of about 250,000 barrels per day this year, versus 283,000 bpd in 1979, as government policy is aimed at restraining output to extend reserves. Nonetheless, net oil export earnings will be up as a result of higher prices. The export outlook for the next few years is highly encouraging. The natural gas project at Bintulu will begin shipping LNG in 1983, with full-scale production of 6 million tons annually expected by 1986. The plantation sector is likely to continue to thrive, and Malaysia will remain the world's leading exporter of natural rubber, palm oil, and tin and become an important exporter of coconut products and cocoa.

Australian agricultural outlook darkened by severe drought.

Severe drought in eastern and parts of western Australia will undermine the Australian agricultural sector's performance in fiscal 1980/81 (ending June 30). In October, the Australian Bureau of Agricultural Economics forecast a wheat harvest of less than 10 million metric tons—40% below last fiscal year— and a 21% decline in overall crop production. Cattle and sheep farmers have also been hit hard. The volume of wool output in fiscal 1980/81 is projected to be down 4% and beef and veal output, down 2%. Higher prices will provide partial compensation to farmers for declines in production, and so far it appears that enough wheat will be available to meet Australia's export commitments. The drought will, however, retard real economic growth and dampen Australia's hopes for a continued major expansion in agricultural exports.

Large oil export earnings buoy Trinidad and Tobago's sluggish economy.

Higher world petroleum prices are the lynchpin of Trinidad and Tobago's recent export strength. With oil accounting for 90% of total exports, foreign earnings in the first half of 1980 were up 67% above receipts in the year-earlier period. The higher oil earnings are almost entirely the result of price rises, since the volume of petroleum exports has increased by only 6% this year. The added earnings are buoying an otherwise sluggish economy. A gradual decline in crude oil output and problems with agricultural crops held real GDP growth to only 3% last year, and economic advance in 1980 is expected to be only marginally faster. Moreover, rising import prices and strains created by the massive industrial investment program now under way have lifted the annualized inflation rate to nearly 19% this year from 15% at end-1979. These pressures have engendered restraint in fiscal and monetary policies. The government, however, has not softened its commitment to building a substantial industrial sector based on the country's ample supplies of natural gas.

Dominican Republic pursuing restrictive policies to check worsening payments balance.

The government of the Dominican Republic has since mid-year pursued restrictive policies to halt a rapidly deteriorating trend in the country's international payments balance. Imports during the first half were 53% above their year-earlier level, and official foreign-exchange holdings in June had declined to about one month's import cover. In response, increases in government spending are being contained, primarily by a freeze on salaries and hiring. This, combined with anticipated revenue increases, should help lower the budget deficit to about 2.5% of GDP from 6% in 1979. On the monetary front, several measures have been taken to reduce domestic liquidity. These include freezing credit issued through the central bank discount facility at its end-1979 level, imposing a 50% reserve requirement on special funds previously exempt, and establishing a 100% reserve requirement on the amount of letters of credit issues for imports not subject to prior deposits. The central bank has also expanded the list of items for which it will no longer provide foreign exchange at the official rate and for which a prior import deposit is required. These measures are expected to limit the total import bill to $1.4 billion in 1980. With export earnings projected at $1.1 billion, a trade deficit of $300 million is thus expected this year, up from the $225-million shortfall of 1979.

Coffee pact endangered by worldwide glut.

The newly formed price-stabilizing pact between the world's coffee producing and consuming nations faces a stiff test in the months ahead as huge excess supply continues to dominate the international coffee market. The U.S. Department of Agriculture estimates that the 1980-81 world coffee crop will total 80.1 million bags, roughly the same as in 1979-80. Only about 25% of the crop is expected to be consumed by the producing nations, which will leave an estimated 60.6 million bags available for export. Members of the International Coffee Organization, in an effort to stabilize coffee prices within a range of $1.15-$1.55 per pound, agreed last month to a quota system that initially limited the volume of coffee exported worldwide to 57.4 million bags. Export demand in the 1980-81 season is expected to be well below this level. The tremendous glut is likely to keep coffee prices near the lower end of the targeted price range and may also spur producers to violate the agreement in search of markets for their surpluses.

Interest Rate Decline in 1981?

Interest rates in both money and capital markets have been exceptionally volatile in recent weeks, as financial markets have been unusually sensitive to any surprises in reported economic and financial data. While this volatility suggests that markets are highly uncertain regarding the near-term course of interest rates, there are indications that most investors anticipate a significant decline in short-term interest rates in 1981.

Since late October, daily interest rate and bond price movements have been quite pronounced. For example, during the first 19 days of November, the average absolute daily change in the 90-day Treasury bill rate was over 30 basis points. Over this same period, the average absolute daily change in 20-year Treasury bond prices was almost 1½ percentage points, or $1.50 per $100 face value. Moreover, intra-day variations in rates and prices were often even more pronounced. Such behavior is reminiscent of the volatility experienced last winter when interest rates rose to record levels.

While the market's perception of the near-term outlook for rates continues to fluctuate wildly, the current pattern of interest rates on 90-day Treasury bill (T-bill) futures contracts suggests that most investors expect that short-term interest rates will drop in 1981. For example, the rate quoted on a futures contract calling for the delivery of 90-day T-bills on June 18, 1981 was about 12% on November 19. This compares with the current rate on T-bills for immediate delivery of about 13¾%. This spread between the current bill rate and the June 1981 futures rate, which is the widest it has been since April, implies that futures market participants expect bill rates to drop significantly by mid-1981.

The yield curve in the Eurodollar market also suggests that most investors in that market expect short-term interest rates to fall in 1981. For example, the rates on three-month, six-month, and one-year Eurodollar deposits on November 20 were about 16½%, 16%, and 14¾%, respectively. If investors as a whole do not believe that three-month Eurodollar deposits will fall sometime in 1981, then a significantly higher expected rate of return could be obtained by investing in three-month Eurodollar deposits and rolling them over than by investing in one-year deposits.

Although markets apparently anticipate a 1981 rate decline, however, it may not necessarily materialize. Both the T-bill futures market and the shape of the Eurodollar yield curve have a number of times in the last two years pointed to market expectations of a rate decline that in fact never materialized. It is still useful, however, to have some idea of what the markets are betting on.

Rising Prices Will Boost Farm Income

There are signs that the decline in net farm income that has continued since mid-1979 is over, but not without inflicting heavy costs. Lower farm income has led to decreased investment and lower agricultural productivity, putting upward pressure on retail food prices. This has been compounded by continued large increases in labor, transportation, and marketing costs. Consequently, consumer food prices may rise faster in 1981 than their 10% clip this year.

Net farm income was $31.0 billion in 1979, second only to record earnings in 1973. But in the first half of 1980, farm income fell to an annual rate of $24 billion. As incomes declined, farmers cut back on expenditures for tractors and other machinery. Adjusted for inflation, such spending dropped more than 25% between the second quarter of 1979 and the second quarter of 1980.

The drop in net farm income was the result of a combination of sharply higher marketing costs and weaker receipts from livestock production in the face of oversupply. Responding to the high prices in 1978 that were associated with cattle herds being rebuilt, hog and poultry producers increased their output. But as more pork and chicken made its appearance on the market beginning in 1979, prices fell, eroding farm incomes.

These declines lasted until the summer of 1980, when severe heat and drought reduced the supply of poultry by about 10% and ended the production gains for pork. Although the heat and drought depressed livestock farmers' production, however, they had a positive impact in spurring price rises. Indeed, prices have reached levels that now make increased production profitable again; they should also be high enough to compensate for the lower output in the near term. The adverse weather conditions also reduced crop yields, but again, sharply higher prices should do much to ease the pain.

The U.S. Department of Agriculture estimates that net farm income stabilized in the second half of 1980. Farm investment has also apparently stabilized. If the increase in farm income for 1981 is as high as the 20%-25% that the USDA projects, spending for farm equipment could also be expected to show a good gain.

Any reduced price pressures from gains in efficiency as investment increases, however, are likely to be more than offset by rapidly rising costs of getting the food from the farm to the table. The farm value accounts only for about 40% of the retail cost of food. The remaining 60% is attributable to marketing costs, such as transportation and packaging. Such costs have increased by 15% in the past year. Thus, although farm price increases in the past year were moderate, retail prices still rose by 10%. As the recent increases in the farm value get passed forward to retailers and marketing costs continue to escalate rapidly, consumers are very likely to see food prices rise more quickly in the months remaining in 1980 and through the first half of 1981.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				central bank rate	exchange rate in U.S. dollars		
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M_1)	November 19, 1980		current monetary conditions	
Austria	Economy signaling slowdown in wake of German slump; mildly restrictive 1981 budget proposed.	Apr.	+ 6.8%	67.9	+ 9.5%	Sept.	4,739	+ 22.0%	2.3	0	Current-account gap of 42 billion schillings foreseen for 1980.	Sept.	+ 6.9%	July	+ 9.5%	6.75%	.0740	Monetary conditions continue restrictive.	**Austria**
Belgium	Budget for 1981 likely to be deflationary despite rising unemployment; industrial output remains flat.	July	− 3.1%	112.4	+ 3.5%	Sept.	8,262	+ 40.8%	1.3	0	Current-account deficit of more than $6 billion officially forecast for 1980.	Sept.	+ 6.8%	June	− 1.6%	12.00%	.03274	Interest rates ease as pressure on franc subsides.	**Belgium**
Britain	No sign yet of recession's end; Sept. industrial output down 9.3% and Oct. unemployment at 7.8%.	Sept.	− 9.3%	399.6	+ 0.9%	Sept.	21,559	+ 8.5%	2.2	828	Trade and current-account balances now showing large surpluses.	Oct.	+ 15.4%	Aug.	+ 4.0%	16.00%	2.3800	Money growth continues rapid, but early MLR cut rumored.	**Britain**
Denmark	Latest figures confirm that GDP growth rate will fall this year, perhaps by 1%, from 1979 pace.	June	+ 6.0%	65.0	+ 3.5%	Sept.	3,166	− 6.1%	2.0	0	Higher oil bill will enlarge 1980 trade gap, despite economic slowdown.	Aug.	+ 11.2%	June	+ 4.0%	12.00%	.1712	DM weakness in EMS allows small interest-rate reduction.	**Denmark**
Finland	Economic output continues to grow, promising the largest 1980 GDP increase in all Europe.	July	+ 8.6%	40.5	+ 6.7%	Sept.	1,942	+ 0.3%	1.5	87	Jan.-Sept. cumulative trade deficit was 5.1 billion markkaa.	Aug.	+ 12.3%	July	+ 9.7%	9.25%	.2655	Monetary policy continues restrictive.	**Finland**
France	Business surveys indicate pronounced downturn in demand.	Sept.	− 5.2%	569.4	+ 3.2%	Sept.	27,686	+ 75.0%	2.5	0	Export orders down; current-account gap to top FF 30 billion in 1980.	Sept.	+ 13.6%	Aug.	+ 9.0%	9.50%	.2270	Exchange rate firm; interest rates decline.	**France**
Germany	Output and orders continue to fall; five institutes now forecast zero economic growth in 1981.	Sept.	− 4.8%	761.7	+ 4.4%	Sept.	49,152	− 6.1%	3.2	0	Current-account shortfall of 30 billion DM expected in 1980.	Oct.	+ 5.3%	Aug.	+ 1.9%	7.50%	.5267	Interest rates stay high in face of weak DM.	**Germany**
Ireland	Recession worsening; retail sales and economic output down 3.5% and 1.5% from year ago.	May	+ 3.9%	14.7	+ 1.9%	Sept.	2,583	+ 22.7%	2.9	0	Current-account deficit now beginning to narrow slightly.	Aug.	+ 18.8%	Aug.	− 1.0%	13.50%	1.9550	Interest rates ease; huge budget gap a limiting factor.	**Ireland**
Italy	Industrial production drops sharply in August; leading indicators point downward.	July	+12.5%	324.2	+ 5.0%	Sept.	21,717	+ 16.1%	2.7	0	Current-account deficit could exceed $10 billion this year.	Oct.	+ 20.5%	May	+17.2%	16.50%	.001105	Credit remains highly restrictive.	**Italy**
Netherlands	Broadly neutral 1981 budget proposed; economy likely to show virtually no growth in '80 and '81.	Aug.	− 2.0%	148.8	+ 2.3%	Sept.	11,460	+ 46.1%	1.7	0	Current-account gap of 4.5 billion guilders likely in 1980.	Sept.	+ 6.9%	July	+ 5.6%	8.00%	.4860	Interest rates ease with guilder strong in EMS.	**Netherlands**
Norway	Despite oil production, the economy is set to slow over the next twelve months.	Aug.	− 4.8%	44.5	+ 3.2%	Sept.	5,057	+ 19.2%	3.7	0	Current account for Jan.-July posts surplus of 2.7 billion kroner.	Sept.	+ 12.7%	July	+ 7.2%	9.00%	.1999	Financial market forces may be given somewhat greater play.	**Norway**
Portugal	Confidence increases somewhat following general election.	Feb.	+16.0%	19.7*	+ 3.2%	Aug.	871	− 3.7%	1.2	155	Tourist season set a record.	Aug.	+ 16.0%	June	+24.9%	18.00%	.0193	Credit relatively restrictive.	**Portugal**
Spain	Economic activity still weak but could be reaching turning point.	Feb.	+ 8.5%	196.0	+ 1.5%	Aug.	13,104	+ 1.7%	4.6	270	Current-account deficit in 1980 could reach $5 billion.	July	+ 14.8%	July	+ 9.5%	8.00%	.0130	Credit still generally available.	**Spain**
Sweden	Orders from abroad falling rapidly; GDP unlikely to grow by more than 0.5% in 1981.	Aug.	+ 1.0%	100.6	+ 3.5%	Sept.	3,575	− 1.3%	1.3	0	Trade deficit for Jan.-Oct. was 11 billion kronor.	Sept.	+ 15.0%	Dec.'79	+16.3%	10.00%	.2325	M_3 growing at 8.7% annualized, slower than domestic prices.	**Sweden**
Switzerland	Continued real economic growth seen for short term; less encouraging outlook for 1981.	June	+ 8.5%	98.0	+ 0.7%	Sept.	14,206	− 5.3%	4.7	0	Current-account gap of SF 2 bn. likely in '80, despite strong export growth.	Oct.	+ 3.6%	July	−11.4%	3.00%	.5855	Monetary policy continues restrictive.	**Switzerland**
Turkey	Economy continues in recession; some supply bottlenecks are easing.	n.a.	—	69.3	+ 1.7%	Aug.	1,186	− 1.9%	2.6	1,159	Import growth accelerates as more foreign finance becomes available.	Apr.	+124.9%	Nov.'79	+55.5%	10.75%	.001137	Monetary conditions continue restrictive.	**Turkey**
Canada	New national energy program aims at 50% Canadian ownership of oil and gas production by 1990.	Aug.	− 3.2%	222.3	+ 2.7%	Oct.	2,727	− 7.0%	0.6	0	Merchandise trade surplus increases significantly.	Oct.	+ 10.9%	Sept.	+ 5.8%	12.67%	.8569	Interest rates rise moderately.	**Canada**
United States	Renewed economic decline foreseen for winter months.	Oct.	− 4.4%	2,368.8	+ 2.3%	Sept.	11,826	+ 61.4%	0.6	0	Trade account improves sharply.	Sept.	+ 12.7%	Sept.	+ 4.8%	12.00%	—	Discount rate raised to 12%.	**United States**

*1978

World Interest Rates

market rates of Nov. 19, 1980; bond yields as of Nov. 14, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00 penalty-lg. bks. 14.00	12.67	16.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.00	7.25
Day-to-Day Money	16.75 Nov. 20	10.50	15.375	8.90	9.75	8.90	17.625	9.125	2.50	9.3115
Treasury Bills 91-day, Middle Rates	13.68	12.60	14.3125	12.50	12.44 one-year	n. a.	15.80 101-day	no dealing	no market	6.375 2-month
Commercial Paper prime, 3-month, asked	13.75 finance paper	12.90 finance paper 15% tax w/h	13.61	11.60 Certified	11.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	15.00	12.65 15% tax w/h	15.0625	11.60 Certified	not traded	9.90	20.70	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	12.45	13.40	12.78	10.613 20% tax w/h	13.74	8.73	16.18	10.44	4.69	8.50
Industrial Bonds prime, long-term, new and old issues, average yield	12.85 Aa Industrials	13.75	13.69	15.64	14.64	9.00	16.30	11.31	5.71	7.23
Bank Short-Term Rate to Best Borrowers (prime rate)	16.25	13.75	17.00	15.75	13.85	11.50	21.00 ⅛ quar'ly fee on outstdng.	11.00	5.50	7.50
Bank Time Deposits 3-month	15.25 Cert. of Dep.	11.25	15.4375	12.50	11.50	9.30	10.75	9.875 large deposits	5.4375 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	15.875	no market	15.6875	no market	11.125	9.25	no market	9.75	5.5625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8569	2.3800	.03274	.2270	.5267	.001105	.4860	.5855	.004707
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	4.00 *P*	.50 *P*	3.375 *P*	4.875 *P*	6.50 *P*	2.00 *D*	6.125 *P*	10.50 *P*	5.625 *P*

Eurodollar Deposits
(London, interbank, bid)
Nov. 20

7-day	16.0625
1-month	16.75
3-month	16.4375
6-month	15.875

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .93
U.S.-Canada Treasury Bills	−2.38
U.S.-Canada Finance Co. Paper	−2.97
Eurodollars-U.K. Local Auth. Deposits	+ .125

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.25
Over 7 yrs.	13.50
DM Bonds	
7 yrs. and under	9.375
Over 7 yrs.	9.50

Gold Price
London
afternoon fixing

629.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	12.7 (Sept.)	10.9 (Oct.)	15.4 (Oct.)	13.6 (Sept.)	5.3 (Oct.)	20.5 (Oct.)	3.6 (Oct.)	8.9 (Sept.)
Industrial production*	−4.4 (Oct.)	−3.2 (Aug.)	−9.3 (Sept.)	−5.2 (Sept.)	−4.8 (Sept.)	12.5 (July)	8.5 (June)	5.9 (Sept.)
Trade balance† *(billions of local currency units)*	−$1.64 (Sept.)	C$0.57 (Sept.)	£0.46 (Oct.)	FF4.46 (Oct.)	DM1.63 (Sept.)	−Lit.2,420 (Sept.)	−SF0.79 (Oct.)	¥423 (Sept.)
Money supply (M_1)*	4.8 (Sept.)	4.9 (Aug.)	4.0 (Aug.)	9.0 (Aug.)	1.9 (Aug.)	17.2 (May)	−11.4 (July)	2.0 (Aug.)
Velocity of money (M_1)*	3.5 (June)	10.7 (June)	11.7 (Mar.)	n. a.	5.8 (June)	4.3 (Mar.)	n. a.	5.7 (June)
Reserves minus gold *($ million, change from previous month)*	310 (Sept.)	−313 (Sept.)	−720 (Sept.)	110 (Sept.)	−1,736 (Sept.)	−604 (Sept.)	1,953 (Sept.)	720 (Sept.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated

Latin American Investment Outlook Bright

The nations of Latin America and the Caribbean are undoubtedly among the world's most promising markets for investment in the coming decades. Their aggregate economic growth rate is expected to continue rapid, and they possess large and expanding domestic markets, elements that have historically proven to be prime magnets for foreign direct investment. Indeed, the *Global 2000 Report*, just released by a special inter-agency group within the U.S. Government, projects that the population of the Latin American region will increase by 2.7% per year over the next two decades, and that real GNP in the period 1985-2000 will rise by 4.5% per annum, on average, the highest of all the world's major regions. *Global 2000* also notes that although many developing countries will show little real per capita gains by 2000, several countries in Latin America are projected to advance significantly over the next 20 years.

Aside from the two key attractions of a growing market and fast-paced economic growth, Latin America and the Caribbean also possess abundant and diverse natural resources, which are largely untapped. Moreover, as such traditional industries as auto production and steel come under more severe competitive pressures in the older industrialized nations, the developing world in general—and Latin America in particular—will offer strong inducements for the establishment of new plants and facilities to serve not only expanding local markets, but also as export platforms for both the developed and other developing-country markets.

Expanding market and vigorous growth

Encompassing a vast land mass, Latin America and the Caribbean constitutes a substantial market of 350 million people. Total GDP of the 39 nations of Latin America and the Caribbean was approximately $600 billion in 1979, or $1,714 per capita. Real per capita GDP, a prime determinant of the attractiveness of investment oriented to the local market, is rising rapidly for a large number of these countries. Argentina, Venezuela, Trinidad and Tobago, and the Bahamas are seeing their per capita GDPs approaching or exceeding $4,000, and the majority of the remaining Latin American nations lie in the middle-income grouping among developing countries.

The Latin American-Caribbean area experienced inflation-adjusted economic growth of nearly 7% per annum in the past decade, well above the 3.5% annual average for the United States and 4% for the OECD nations. Indications are that the 1980s will see the pattern repeated, with Latin America and the Caribbean recording average annual GDP growth of 5%-6%. Such an economic growth rate is quite favorable when compared with average annual growth of some 3%-4% foreseen for the industrialized West and Japan during the next decade.

A wealth of natural resources

The Latin American region is a veritable treasure-house of natural wealth, holding particularly great promise for investors seeking to develop oil, gas, mineral, oceanic and agricultural resources. In terms of mineral reserves, Chile and Peru are major repositories of copper; Jamaica is one of the world's principal sources of bauxite; Brazil has vast iron ore deposits still to be developed; and coal is just beginning to be mined in Colombia. Mexico, Trinidad and Tobago, Venezuela, Ecuador, Peru, and Argentina are endowed with significant deposits of oil and gas. And the region's great hydroelectric power potential is underscored by the construction now under way at the Itaipu hydroelectric plant on the Parana River bordering Brazil and Paraguay. When its almost 13,000-megawatt capacity is installed, the Itaipu plant will be the largest such facility in the world.

RESERVES OF SELECTED MINERALS IN THE LATIN AMERICA-CARIBBEAN AREA

	Major Reserves (% of World Total)	Major Producers
Bauxite	Surinam (11) Jamaica (5)	Jamaica (14) Surinam (6) Guyana (4)
Bismuth	Latin America (21)	Latin America (48)
Columbium	Latin America (45)	Brazil (7)
Copper	Chile (19) Peru (8)	Chile (13) Peru (5)
Iron Ore	South America (19)	Brazil (9)
Molybdenum	Chile (16)	
Nickel	Cuba (24)	
Silver	Mexico (13)	Mexico (15)
Tin	Bolivia (10)	Bolivia (13)
Tungsten	Bolivia (3)	

Source: World Bank and U.S. Bureau of Mines

Latin America's long-term agricultural prospects are also encouraging. The *Global 2000 Report* projects that the nations of this region will see their total food production increase by more than 184% between 1970 and 2000, with consumption rising by a more moderate 165%. The Report predicts that Latin America will be the only developing region where average per capita food consumption in the year 2000 will be more than 20% above the U.N. Food and Agriculture Organization's minimum caloric standard.

Latin American Investment Outlook Bright *(continued from page 7)*

Foreign investment on the rise

Many of Latin America's industrializing nations will undoubtedly attract a large share of the world's industry in the coming decades because of their large and well-trained labor forces; expanding technological base; ample financial intermediaries; and their generally more accommodating and pragmatic attitude to foreign investment.

Moreover, as comparative advantages are eroded in the more mature industrialized nations, investors will be motivated to invest more heavily in such semi-industrialized nations as Mexico, Brazil, and Argentina, which have already established a variety of new industries. The world automotive industry is a prime illustration. As profitability has plunged in many industrialized-nation producers, major investments have been funnelled to Mexico, Brazil, Argentina, Colombia, Peru, and Venezuela. Other good candidates for a shift to the newly industrialized nations include the electronics, chemicals, steel, assembly, shipbuilding, and food processing industries.

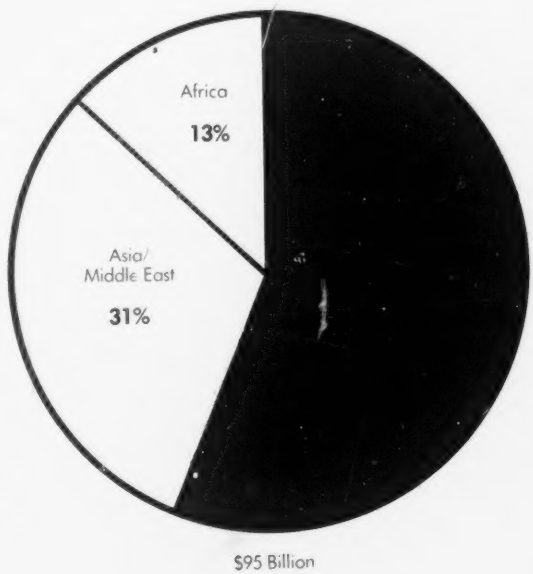
The largest single foreign investor in Latin America is clearly the United States. The region was the recipient of $37 billion of U.S. investment, or 19% of total U.S. foreign investment, as of end-1979. More significantly, U.S. investment in Latin America at end-1979 came to 77% of total U.S. investment in the developing regions of the world, far surpassing investment in Africa and Asia. Responding to the attraction of a growing class of middle-income consumers, nearly all of recent U.S. manufacturing investment in the developing world has gone to Latin America. In fact, Latin America is keeping pace with Europe as the locus of major new U.S. investments. Since 1977, U.S. investment in Latin America has grown by 31%, compared with the 33% gain in U.S. investment in Europe during the same period.

Foreign investment in the Latin American-Caribbean area, however, is not only a U.S. franchise. In the last decade, European and Japanese firms have penetrated the region to a significant degree. Indications are that German and Japanese investment in the region has doubled in the last 10 years. In fact, total foreign direct investment by the industrialized nations in the Latin American-Caribbean area now represents 56% of all developing-region investment, with 31% going to the Middle East and Asia and 13% to Africa.

The most important Latin American markets for foreign investment have been Brazil and Mexico. As of end-1979, U.S. direct investment in Brazil was $4.4 billion, some 27% of the $16 billion of all foreign investment in that country. German investment in Brazil totaled $2.5 billion, and Japanese holdings were roughly $1.5 billion. And while U.S. investment in Brazil rose by 16% between 1970 and 1979, German firms expanded by 18%. European and Japanese foreign direct investment is also rising in Mexico, challenging the United States' traditionally preeminent role. Of the $6.8 billion of total foreign private investment in Mexico in 1979, the U.S. share was 70%, compared with an 81% U.S. share in 1971.

Leading Region For Foreign Investment In Developing World

1979



Source: United Nations and Chase Economics Group

Increased competition for financial services

Reflecting the burgeoning investment opportunities in the Latin American-Caribbean region, competition for financial intermediaries is heating up. The large U.S. banks are expanding the scope of their activity, and other international banks are beginning to establish themselves in the region. Local Latin American banks are adding to the competition by establishing offices abroad and participating in international credits. And such international multilateral institutions as the World Bank and the Inter-American Development Bank will play an increasingly important role as providers of official credits. Thus, the expectation of adequate financial resources will help drive the engine of economic development as both local and foreign investors tap the vast economic potential of Latin America in the coming decades.

A. Blake Friscia

CHASE

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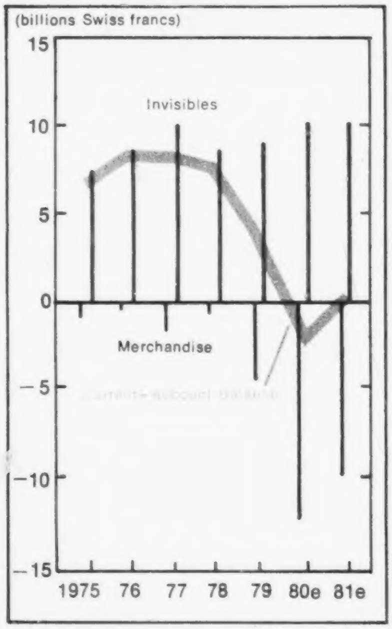
A Turnaround for the Swiss Current Account

Switzerland will register its first current-account balance-of-payments deficit since 1965 this year. Although the traditional net surplus on the invisibles account is growing, the Swiss trade balance has deteriorated sharply. The causes are twofold: a negative swing in the Swiss terms of trade and the relative buoyancy of the domestic economy.

The trade deficit piled up in the first nine months of 1980 exceeded 9 billion Swiss francs, compared with a shortfall of SF 3.3 billion in the January-September 1979 period. Imports are running some 29% above their year-earlier level, owing to a 25% increase in prices. Oil is not the only culprit, however, as crude oil imports are equivalent to less than 11% of total merchandise imports. More important has been the strength of domestic economic activity, which has led to a large increase in raw material and capital goods imports. Thus, despite a strong performance by an export sector still recovering from the Swiss franc's appreciation in late 1978, the trade balance is likely to be 12 billion francs in the red this year. By comparison, the trade-account shortfall was only SF 520 million in 1978 and SF 4.7 billion last year.

Swiss external account balances



Switzerland's perennial invisibles surplus is expected to widen this year. Earnings from interest, profits, and dividends from overseas investment will total more than 7 billion francs this year, and tourist receipts will add another SF 2 billion. Both invisibles categories will post higher earnings this year than in 1979, particularly income from tourism, which has bounced back from its depressed levels in the late 1970s. With an invisibles surplus projected at some SF 10 billion in 1980, the current account will shift into a deficit of approximately SF 2 billion. This represents a net deterioration of more than 10 billion francs on an annual basis from the surpluses recorded in both 1976 and 1977. Last year, the surplus on current account was slightly more than SF 4 billion.

Some improvement in the Swiss overseas trade performance is foreseen for 1981. If oil prices do not rise by much more than 20% through 1981, the total import bill may not increase greatly as import volume is expected to be reduced substantially because of the domestic economic slowdown likely in the first part of 1981. Nonetheless, export volume is already falling off as recession deepens in the economies of Switzerland's major trading partners—especially Germany. Consequently, a marginal reduction in the trade deficit, combined with continued buoyancy of invisibles earnings, may put Switzerland's 1981 overall current account in rough balance.

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U.K. interest-rate reduction feared to be premature.

The U.K. recession has evolved into the worst economic slump since World War II. Official forecasts have been revised downward once again; the current expectation is that GDP will decline by about 3% in 1980 and by another 1½% in 1981. On the positive side, the balance of payments is expected to register a large surplus both this year and next, while the rate of inflation will continue its decline through 1981, falling to an officially estimated annual rate of 11% by the fourth quarter of next year. Despite the economic weakness, the British Chancellor's recent statement to parliament reaffirmed the government's long-term commitment to a policy of domestic restrictiveness. The budget for fiscal 1981/82 calls for additional, and sharp, cuts in public spending, an £800-million reduction in borrowing by nationalized industries, an additional 20% tax on oil company revenues, an increase in national insurance contributions, and less than full indexation of pensions and other benefits. Curiously—and significantly—the authorities have also cut the Bank of England's minimum lending rate (MLR) to 14% from 16%. When the MLR was cut to 16% from 17% in July, the government argued that the monetary statistics would soon justify the reduction. But subsequent sterling M_3 money supply developments pointed to the maintenance of at least a 17% rate. Thus, cutting the MLR to 14% is a gamble based on the assumption that the recent rapid growth in the M_3 money supply will ease. If the government proves correct, interest rates will follow a steady downward path. But if the authorities are wrong, doubts about the MLR cut will increase, as will suspicion that a significant loosening of monetary policy is being pursued. This could lead to a reassessment of economic prospects and may trigger higher wage settlements, which in turn would keep interest rates from falling—possibly even boosting them higher.

Israeli inflation rate accelerating, but trade accounts have improved.

The Israeli economy remains plagued by high inflation. Deflationary measures adopted last fall secured some reduction in the pace of inflation during the first half of 1980. But a pick-up in economic activity around midyear led to a fresh round of 8%-10% monthly hikes in the consumer price index. The rate of inflation is now expected to reach 160% on an annual basis by yearend, despite real 1980 GDP growth projected at only 1.5%. Political pressure is mounting for the Likud government to reduce inflationary pressures. But a Bank of Israel proposal to seek a wage-price accord was thwarted by the Histadrut (the labor federation). In addition, new initiatives to stem government spending—which led to Ezer Weizmann's resignation from his defense post in the Begin cabinet— are currently bogged down. A positive element in the economic sphere, however, is Israel's improved trade performance. The January-September trade deficit amounted to $1.9 billion, slightly less than the shortfall recorded in the year-earlier period. The trade accounts have been buoyed by strong export growth and weak import volume growth attributed to the domestic economic slump.

Brazil modifies its indexation system to boost savings and exports.

Brazil has liberalized its system of comprehensive indexing of financial instruments and the cruzeiro exchange rate. Savers and exporters had argued that the previous ceiling on indexation failed to compensate for the 100% inflation experienced in the latter part of this year. Under the new guidelines, monetary correction will be keyed to a national consumer price index, and the exchange rate will be devalued in accordance with the differential between internal and external inflation. If these policy changes achieve their purpose, they should boost domestic savings by making financial instruments more attractive and increase foreign-exchange earnings by making exports more competitive. These would help curb Brazil's external finance requirements. Brazil has already managed to obtain the needed finance for 1980 through a considerable gain in export earnings, external borrowings, and via drawdowns of international reserves. The increased incentives engendered by the new indexation system should help Brazil satisfy its financing needs in 1981.

Jamaica looking to the IMF for aid in easing foreign-exchange crunch.

The most serious problem facing Jamaica's new president Edward Seaga is a severe foreign-exchange shortage. The country's international reserves are negligible, and its net foreign asset position is more than $800 million in the red. Moreover, Jamaica's external debt totals $1.8 billion, equal to about 60% of GDP. Critical to easing the foreign-exchange crunch is financing from the IMF, with whom negotiations were broken off last March. Jamaica is anticipating funds of up to $570 million from the IMF over the next three years, the maximum entitlement under the extended facility arrangement. After repayments due, however, net new lending by the IMF will come to only $250 million. Consequently, the authorities are also counting on rescheduling some $825 million owed to international commercial banks and the Paris Club. At the same time, they are looking to the Venezuelan/Mexican oil rebate facility to provide credit of up to $100 million next year and are soliciting other sources of bilateral and multilateral assistance.

Argentine tax changes boost inflation but should have positive long-term results.

After declining steadily throughout most of the year, Argentina's inflation rate spurted upward in October. The consumer price index rose 7.6%, with wholesale prices advancing 5.5%. This compares with a September increase of 4.5% in consumer prices and 2.8% in wholesale prices. The consumer price jump in October brought the annualized inflation increase to nearly 90% from 84% in September, reversing the downward trend that had seen the annualized rate decline from 140% in December 1979. The October spurt was the result of recent major changes in the Argentine tax system. The value-added tax has been boosted and extended to cover a larger number of goods and services. At the same time, a number of business taxes and social security charges have been either lowered or eliminated to assist firms squeezed between a slowly depreciating currency and rising domestic costs. Although the tax modifications will boost the price level in the near term, improved earnings should materialize for exporters and import-competing businesses caught in the inflation-devaluation bind.

Philippine government taking concrete measures to reduce oil-import dependence.

The Philippines is one of the few oil-importing developing countries to be following a coherent energy program aimed at lessening oil-import dependence. Recent price increases will swell the oil import bill to $2.4 billion this year, 40% of export earnings. Consequently, the government is banking on an expansion of domestic output that will reduce the percentage of total energy needs satisfied by imported oil to about 41%. In addition, the government has shortened the time span in which the energy program targets are to be achieved from ten to five years. The accelerated program envisages cutting the percentage of oil in total energy usage from 93% in 1979 to 55% by 1985. Use of coal, hydroelectric, nuclear, geothermal power, and non-conventional sources such as alcogas are also set to expand. The cost of the five-year energy program is estimated at $9.5 billion, about half of which will be in foreign exchange. Considering other demands on the Philippines' financial resources, it is possible that the targets will be missed by one year or so. Still, the authorities appear determined, and the program seems technically sound and enjoys the support of international lending institutions.

Korean economy to contract sharply in 1980.

The deep recession that has hit the Korean economy this year is showing only a few signs of ending and will likely continue through the first half of 1980. Yearend 1980 data is expected to show a GDP decline of 5%-6%, a current-account deficit of some $5.3 billion, and consumer price inflation of more than 30%. The authorities have undertaken reflationary measures—including reducing interest rates—to ease the financial strains on business and limit unemployment. And the won exchange rate has been allowed to depreciate to enhance export competitiveness. In addition, energy prices have been raised to limit domestic oil consumption. The recent signals of economic improvement include a slight decline in producer inventories and a revival of export orders. Export letter-of-credit arrivals in September and October were up 47% above their level in the comparable 1979 period.

New Corporate Bond Issues Decline

The volume of new corporate bond offerings dropped sharply in November, totaling only $0.9 billion, or $1½ billion less than in October. This pace is a far cry from the activity at midyear, when offerings were in the $5-$6 billion range. Indeed, the November total represents the smallest dollar volume of new corporate issues in any month since September 1973. In this environment, there is increased market apprehension that the greater reliance on short-term debt has heightened borrower sensitivity to near-term swings in interest rates.

The recent declines in long-term financing reflect the unwillingness of firms to assume long-term debt at borrowing costs near record levels in a highly volatile and uncertain market. They also reflect an inability to tap sources of long-term credit for sizable amounts of funds at current rates.

Over the course of 1980, changes in the volume of new bond issues have been quite sensitive to changes in long-term interest rates. Corporations responded to the substantial decline in bond rates earlier this spring by bringing a record volume of new bond issues to the market. For example, May's increase of $3.3 billion over April (to a volume of $6.4 billion) corresponded to almost a 75-basis point decline in Aa utility rates—from roughly 12¾% to about 12%. And the recent decline in new bond issues has been in response to the run-up in rates of the last few months.

The recent drop in corporate bond offerings has been more than made up for by increases in short-term business credit. For example, during the first three weeks in November, business loans at large banks surged by almost $3½ billion and nonfinancial commercial paper rose by almost $900 million. This rapid increase in short-term credit demand has contributed to the recent upward pressure on money-market rates.

Corporate funding patterns during 1980 indicate just how sensitive the composition of corporate debt is to changes in interest rates. This has implications for the behavior of various credit measures as well influencing whether the increasing reliance of corporations on short-term debt will continue.

If bond market conditions improve dramatically in the near term and long-term rates fall, then the volume of new corporate bond issues will probably jump to levels similar to those of mid-1980. This in turn would lead to a sharp reduction in the growth of bank loans and commercial paper.

If, however, conditions in the bond market remain unfavorable much longer, the market's fears that certain corporations will become too heavily burdened with short-term debt may be substantiated.

A New Slump in Consumer Spending?

In the face of rising interest rates that are pushing last spring's heady levels, concern about the specter of a new downturn in the U.S. economy is high. So far, there are ominous signals that the economy is indeed slowing down in response to higher interest rates. Sales of new and existing homes have fallen off again after a sharp recovery over the summer, auto sales have failed to improve as expected with the introduction of the 1981 models, and building permits for residential construction declined 15% in October, foreshadowing further weakness ahead. But most important is the outlook for consumer spending, which accounts for roughly two-thirds of GNP. If a renewed recession develops, a turndown in consumption expenditure will almost surely lead the way. And the determinants of consumer spending do seem to suggest a downturn.

The unanticipated acceleration of inflation, partly the result of higher energy prices, and the progressive income tax structure have actually kept real disposable personal income from growing for nearly two years. But throughout 1979 and early 1980, consumers supplemented their shrinking real incomes by borrowing heavily to augment their buying power. Consumer credit as a source of strength faltered in March 1980, however. Interest rates had soared to levels that made lending to consumers unprofitable (especially where usury ceilings were activated), and the Federal Reserve's implementation of controls on the issuance of consumer and other forms of credit sent retail sales reeling. Net liquidation of consumer instalment debt in the spring eliminated $35 billion from consumers' purchasing capacity (at an annual rate) in contrast to net accumulation of debt of $40 billion a year earlier.

Interest rates fell sharply and the credit controls ended early in the summer. Consumers were once again willing and able to borrow more freely, although at a sharply lower rate than in the first quarter of 1980. Consumer spending was further bolstered as Social Security beneficiaries' incomes received an $18-billion boost in July. Mirroring these developments, retail sales increased at a 23% annual rate in the June-September period.

With real disposable income failing to show any growth since July and interest rates again at levels that discourage consumer lending, however, it is hardly surprising that consumption is beginning to stagnate—as suggested by the 0.1% decline in retail sales in October. And consumer buying power will suffer further beginning January 1, 1981 when the payroll tax for Social Security rises 0.5%. Thus, forces are in place to bring about a new slump in consumer spending, even if credit controls are not reimposed and interest rates remain stable. A sizable tax cut in mid-1981 would thus be necessary to trigger a renewed, extended upsurge in consumer spending, and consequently, a sustained economic recovery.

Asia and Oceania

Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes latest data	consumer prices	latest data	money supply(M_1)	exchange rate in U.S. dollars December 3, 1980	change from year earlier December 3, 1980	current monetary conditions	
Bangladesh	Agricultural prospects favorable, with record food storage expected.	June	+ 15%	9.9	$ 116	Oct.	185	− 56%	0.9	167	Rice exported and cheaper wheat imported to earn foreign exchange.	June	+12%	July	+16%	.0700	+14%	Bank rate and interest rate on deposits raised.	**Bangladesh**
Burma	Policy of running government-owned enterprises on commercial basis yields positive results.	July	+ 17%	5.0	154	Oct.	240	+ 26%	8.6	60	Oil self-sufficiency and rising exports improve trade balance.	Aug.	+ 1%	Sept.'79	+14%	.1565	+ 2%	Inflation rate under 10%.	**Burma**
China, People's Republic	Smaller grain harvest will restrain economic growth over the next 12 months.	June	+ 45%	515.0	510	Mar.	1,918	− 25%	1.4	0	Petroleum exports to Japan to fall short of commitments.	n.a.	—	—	—	.6800	0	IMF boosts Fund quota to SDR 1.2 billion.	**China, People's Republic**
Hong Kong	Property and stock market boom continue, although exports are down.	Aug.	+ 30%	17.6	3,320	n.a.	—	—	—	—	Recent tourism upswing helps narrow current-account deficit.	Sept.	+14%	Aug.	+31%	.1958	− 3%	High interest rates beginning to bite.	**Hong Kong**
India	Industrial output growth rising in second half of fiscal 1980/81.	June	− 24%	126.3	194	July	6,764	− 8%	7.0	343	Foreign-investmant policy concessions made to attract petrodollars.	Aug.	+10%	May	+10%	.1275	+ 3%	More flexible exchange-rate policy adopted.	**India**
Indonesia	Oil exploration spending surges, with new leases granted; oil output expected to rise.	Feb.	+ 50%	47.1	317	Oct.	6,101	+ 61%	8.4	0	Exchange rate stable despite large payments surplus and rising reserves.	Sept.	+15%	July	+50%	.001610	+ 1%	Budget for FY 1981/82 is expansionary.	**Indonesia**
Japan	Domestic demand continues extremely sluggish.	Aug.	+ 26%	1,011.0	8,725	Oct.	24,055	+ 7%	1.9	0	Curent account should approach balance in fourth quarter.	Aug.	+ 9%	Sept.	− 4%	.004680	+13%	Continued cautious easing of monetary policy.	**Japan**
Korea	Real GNP this year will decline by 5%-6%.	Aug.	+ 15%	60.1	1,598	Sept.	3,714	+ 33%	1.8	626	Exports show signs of recovery, led by heavy industry.	Sept.	+30%	Sept.	+21%	.001640	−21%	Credit eased to relieve ailing industries.	**Korea**
Malaysia	Rising real income supports boom in property and stock markets.	Mar.	+ 38%	19.4	1,457	Aug.	4,482	+ 17%	5.3	0	Surge in capital goods imports narrows trade surplus.	Sept.	+ 6%	July	+17%	.4550	− 1%	Interbank liquidity easing somewhat.	**Malaysia**
Pakistan	Prices raised to reduce subsidies and boost profitability of public-sector enterprises.	June	+ 32%	23.0	288	Oct.	404	+164%	1.1	308	Exports in July-September period rose 18% from previous year.	June	+11%	June	+17%	.1020	+ 1%	Three-year loan of $1.7 billion granted by IMF.	**Pakistan**
Philippines	Recession affects many industries, but several major new foreign investments reported.	May	+ 34%	29.4	617	Oct.	2,535	+ 21%	4.0	814	Reduced oil consumption, improved sugar exports moderate trade deficit.	Sept.	+14%	July	+13%	.1360	+ 1%	Tight fiscal management follows IMF guidelines.	**Philippines**
Singapore	High wage policy may be maintained through 1982.	July	+ 46%	8.9	3,790	July	6,210	+ 12%	3.2	0	Proposed industrial cooperation with PRC may lure multinational investment.	Sept.	+ 7%	June	+18%	.4757	+ 3%	High interest rates maintained.	**Singapore**
Sri Lanka	Taxes raised, prices boosted, and spending cut to reduce budget deficit.	June	+ 19%	3.3	226	May	401	− 6%	2.4	299	Investment promotion targeted more at specific countries and firms.	Aug.	+33%	May	+24%	.0580	−10%	New fiscal measures may ease credit growth.	**Sri Lanka**
Taiwan	Continuing stability and prosperity attract foreign (including European) banking interests.	Sept.	+ 23%	32.2	1,840	July	2,[illegible]72	+ 24%	2.1	0	Small trade deficit will result from current export slump.	Aug.	+18%	Sept.	+17%	.0290	0	Government pursuing high-interest-rate policy.	**Taiwan**
Thailand	Increased agricultural output and reduced border tensions boost business confidence.	July	+ 31%	27.3	591	Oct.	1,808	− 1%	2.8	213	Trade deficit widening because of oil imports.	Sept.	+17%	June	+15%	.0510	+ 4%	High interest rates being maintained.	**Thailand**
Australia	Relatively conservative fiscal and monetary policies likely to continue with Fraser victory.	Sept.	+ 19%	119.1	8,253	Oct.	1,900	+ 31%	0.7	162	Pressures persist for reductions in tariff barriers.	June	+11%	Aug.	+12%	1.1645	+ 6%	Credit squeeze likely in first half of 1981.	**Australia**
New Zealand	Stimulative fiscal measures to take effect in early 1981.	Aug.	+ 16%	17.5	5,651	Oct.	546	− 19%	0.8	207	France blocking agreement concerning 1981 butter exports to EEC.	June	+18%	Aug.	+15%	.9565	− 3%	Trading-bank lending 13% ahead of year-ago level.	**New Zealand**
Papua New Guinea	High rate of government spending causing concern as inflation rate doubles.	Jan.	+ 31%	1.8*	620	Oct.	499	− 18%	5.7	6	Aid from Australia to decline in real terms.	June	+13%	Sept.	+10%	1.5385	+ 9%	Exchange-rate revaluation policy coming under attack.	**Papua New Guinea**

*1978

World Interest Rates

market rates of Dec. 3, 1980; bond yields as of Nov. 28, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00 penalty-lg. bks. 14.00	13.95	14.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.00	7.25
Day-to-Day Money	17.25 Dec. 4	13.25	13.75*	8.65	10.875	9.10	17.625	9.25	4.50	9.625
Treasury Bills 91-day, Middle Rates	14.60	14.30	13.375*	12.75	n. a.	n. a.	15.699 87-day	no dealing	no market	5.875 2-month
Commercial Paper prime, 3-month, asked	14.25 finance paper	14.50 finance paper 15% tax w/h	12.85*	11.60 Certified	11.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.85	14.50 15% tax w/h	13.6875*	11.60 Certified	not traded	9.90	20.70	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	12.30	13.40	13.17	10.678 20% tax w/h	13.68	8.76	16.18	10.37	4.68	9.031
Industrial Bonds prime, long-term, new and old issues, average yield	12.85 Aa Industrials	13.90	13.63	13.564	14.69	8.97	16.28	11.24	5.59	7.27
Bank Short-Term Rate to Best Borrowers (prime rate)	18.50	15.00	15.00*	15.75	13.85	11.50	21.00 ⅛ quar'ly fee on outstdng.	11.00	5.50	7.50
Bank Time Deposits 3-month	16.875 Cert. of Dep.	13.00	15.4375*	13.00	11.6875	9.75	10.75	9.875 large deposits	6.00 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	18.0625	no market	14.875	no market	11.75	9.75	no market	9.875	6.00	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8370	2.3480	.0320	.2219	.5148	.001084	.4752	.5703	.004680
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	3.625 *P*	3.00 *P*	4.75 *P*	6.00 *P*	7.875 *P*	FLAT	7.75 *P*	11.625 *P*	6.75 *P*

Eurodollar Deposits
(London, interbank, bid)
Dec. 4

7-day	18.3125
1-month	18.875
3-month	18.50
6-month	16.875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	n.a.
U.S.-Canada Treasury Bills	−2.67
U.S.-Canada Finance Co. Paper	−3.675
Eurodollars-U.K. Local Auth. Deposits	n.a.

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.625
Over 7 yrs.	14.00
DM Bonds	
7 yrs. and under	9.20
Over 7 yrs.	9.375

Gold Price
London
afternoon fixing
627.25
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of Nov. 27.

Key Indian Economic Indicators

	FY*1977/78	1978/79	1979/80	1980/81**	1981/82**
Real GDP Growth, %	7.7	4.9	−3.0	6.0	3.6
Wholesale Price Inflation, %	5.2	0	16.7	13.0	12.0
M_2 Growth, %	20.3	21.5	17.3	16.0	15.0
Trade Balance (million $)	−715	−1,297	−2,800	−4,800	−5,500
Current-Account Balance (million $)	807	500	−750	−2,600	−3,300
Reserves/Average Monthly Imports	9.4	10.1	8.4	6.5	5.4
Exchange Rate (rupees per U.S. $)	8.563	8.206	8.076	7.8	8.0

* Fiscal year runs April through March
** Estimated

Capacity Constraints Limit India's Growth

India's $126-billion economy is characterized by heavy dependence on imported oil, widespread infrastructural bottlenecks, and an agricultural performance that remains highly dependent on the weather. Consequently, real GDP declined by about 3% in fiscal 1979/80 (ended in March 1980) in the wake of a doubling of oil import costs and a severe drought that depressed agricultural output and aggravated energy supply bottlenecks. The government of Indira Gandhi has responded to the poor economic showing by enacting measures aimed at alleviating the infrastructural bottlenecks, reducing dependence on imported oil, and dampening the recent surge in inflationary pressures. Economic propsects for fiscal 1980/81 and thereafter will depend to a large degree on the success of these measures and the government's determination to see them through.

Domestic economy rebounding

India's poor economic showing last fiscal year was in sharp contrast to the real economic growth rate of nearly 5% achieved in fiscal 1978/79 and the 7.7% posted in FY 1977/78. The major causes were a 10% drop in agricultural output triggered by the drought and a stagnant industrial performance attributable to political uncertainty, labor unrest, and power and transport bottlenecks.

A return to positive real economic growth is envisaged for the current fiscal year; indeed the country's sixth five-year plan—including fiscal 1980/81 and running through 1984/85—has targeted an average annual real economic growth rate of 5.3%, with annual growth of 4% in agriculture and 8%-9% in industry. To achieve such results, the authorities plan to emphasize the development of agriculture, power, transport, domestic energy sources, and job creation.

India's 1980/81 budget underscores the new approach by boosting public spending on oil exploration by almost 35% and increasing investment in the state-owned coal and steel industries by 33% (although public investment in electric power will rise by only 11%). Resources have been allocated to improve rail transport, and the government is committed to enhancing management efficiency in key state industries. In the agricultural area, the authorities are likely to sustain their efforts to increase irrigation, introduce higher-yield seeds, and expand fertilizer use. Finally, to spur sluggish private investment in industry, the government has relaxed licensing restrictions to allow private productive capacity to expand. It has also moved to permit increased foreign technological collaboration and has adopted various fiscal incentives.

Real GDP growth in the current fiscal year is projected at 6%—a sharp rebound from the negative growth in fiscal 1979/80. Plentiful rainfall—still the lynchpin of agricultural performance—will permit agricultural growth of 10%-11%. Although the public-sector enterprises are performing more strongly than last year, industrial production has remained stagnant as a result of persistent bottlenecks, reduced agricultural incomes brought on by last year's drought, and the worldwide economic slowdown. The abundant rainfall this year has alleviated the infrastructural bottlenecks somewhat by boosting the supply of hydroelectric power. But the main problem is one of inadequate infrastructural capacity, which will limit industry's growth rate to 3%-4% in 1980/81 and constrain output over the medium term.

Looking out to fiscal 1981/82, the agricultural growth rate is expected to return to a more normal 2.5%-3%, assuming favorable weather. If infrastructural bottlenecks continue to ease and the official policies succeed in spurring private-sector enterprise, a 6%-8% growth in industrial output is possible. With these assumptions, GDP growth would be about 3.6% in fiscal 1981/82, suggesting that the government's five-year plan targets are rather optimistic.

Inflationary pressures reemerging

Last fiscal year marked the end of a period of relatively low inflation. Wholesale prices in fiscal 1979/80 increased by an average of 16.7%, after nearly zero wholesale price inflation in 1978/79. The resurgence of inflation was caused by an excess supply of money. The government budget deficit ballooned in fiscal 1979/80 because of a drought-induced spurt in government spending and reduced revenues associated with a weak economy. As a result, the rate of money supply (M_2) growth—which had been 20% in each of the two previous years—only fell to about 17%. At the same time, the demand for real money balances declined sharply in response to falling real income, and the resulting excess supply of money put upward pressure on prices. A large rise in the price of traded goods, particularly of imported petroleum products, added to the upward pressure.

Although planned reductions in government subsidies will exert upward pressure on prices in 1980/81, such cuts should improve the longer-term outlook for inflation by reducing the budget deficit and permitting a lower rate of domestic credit expansion. If money supply growth approximates its 1979/80 pace in the current fiscal year, and the demand for real money balances picks up as real income climbs, the rate of wholesale price inflation may drop to about 13% in 1980/81. Further significant moderation in in-

Capacity Constraints Limit India's Growth *(continued from page 7)*

flation appears unlikely in fiscal 1981/82.

External-payments balance deteriorating

India's trade balance worsened considerably last year. The country's trade deficit widened from $1.3 billion in fiscal 1978/79 to $2.8 billion in FY 1979/80. Export volume fell slightly, owing mainly to the weak domestic economic showing and labor problems, but also because of the de-emphasis of exports by previous governments. Import volume growth was moderate, reflecting depressed domestic income and caution in the implementation of the government's more liberal import policy. In value terms, exports rose only 8% last fiscal year, while imports jumped nearly 25%. The higher import bill reflected higher prices for all major imports, but was primarily the product of sharply higher oil and fertilizer import costs. Compounding the problem was the prolonged political agitation in Assam, one of India's three major oil-producing areas, which halted production and further increased India's oil import requirements. Consequently, the petroleum import bill more than doubled to $4.75 billion. Heavy inflows in the form of workers' remittances from abroad offset the trade shortfall only partially, leaving India with a current-account deficit of $750 million, a sharp reversal from the $500-million surplus in fiscal 1978/79.

The deteriorating external-payments situation has also manifested itself in an alarming decline in India's international reserves since the beginning of 1980. To address the problem, the Gandhi government has taken steps to foster export-oriented activity. It is also seeking to step up domestic oil production by inviting foreign firms to participate in exploration and development. And it is attempting to reduce the oil import bill by obtaining concessional terms from OPEC members. In other efforts to improve its balance of payments, India is acting to boost oilseed output, spur the production of such products as cement and steel (currently imported in large quantities), encourage Indians abroad to transfer home larger earnings, and solicit direct investment from OPEC. India's liberalized import policy, which is aimed at enabling industry to obtain needed inputs, will continue, but imports deemed unnecessary (such as consumer goods) will likely continue to be restricted.

Despite these initiatives, India's payments balance will probably deteriorate further in fiscal 1980/81 and again in 1981/82. Persistent power shortages, transport bottlenecks, and growing domestic demand for commodities, together with the worldwide economic slowdown, are likely to depress sales abroad. Total exports are thus expected to increase by 10%, at best, in 1980/81. Imports of such products as steel and cement should decline as domestic production picks up, and non-oil imports will likely be restrained because of balance-of-payments pressures. But total import costs will still rise by 25% or more, largely because of higher-priced oil. Iran and Iraq together had satisfied nearly two-thirds of India's oil import needs before the outbreak of war in the Mideast, and with the disruption in oil supplies, these needs must now be met at least in part through higher-priced spot-market purchases. As a result, India's oil import bill could approach $7 billion in 1980/81. Thus a trade deficit of some $4.8 billion is projected for 1980/81, with the current-account gap likely to widen to $2.6 billion.

If the government's efforts to stimulate exports are maintained in 1981/82, and infrastructural deficiencies are partly alleviated, exports could grow by 12%-14%. But even with a slowdown in import growth, India will still likely face a trade deficit of more than $5 billion and a current-account gap of over $3 billion in fiscal 1981/82.

The prospect of rapid external-account worsening is especially disturbing at a time when net foreign aid disbursements are falling off. External aid was sufficient to finance the 1979/80 current-account gap, even permitting total reserves to rise somewhat. But the deficits anticipated for the next few years will likely exceed net aid disbursements, given the unfavorable aid climate. Unless imports are cut back substantially or aid commitments boosted sharply, India may have to seek increased IMF funds (to supplement the $1.04 billion recently provided through the IMF's Compensatory Financing and Trust Fund facilities) or turn to the world capital markets to avoid a large loss of international reserves. Even so, India's reserves are expected to decline to less than six months of import cover by the end of fiscal 1981/82.

Although India's problems are serious, the Gandhi government has demonstrated that it has the power and the will to adopt the needed corrective policies. The crucial question is whether Indira Gandhi will be able to maintain her current mandate—which is reflected by a two-thirds majority in parliament—and quell internal unrest to prevent any major disruption of the economy. Furthermore, given India's history of dramatic reversals in policy, the Indian authorities will also have to convince private business that the current policies will be sustained. *Melanie L. Lau*

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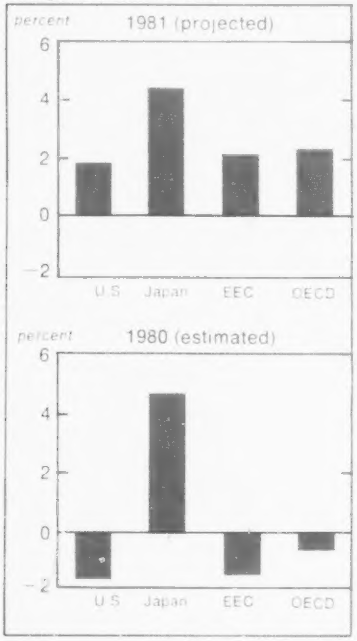
The World Economy in 1981—OPEC Willing, a Weak Recovery

Barring another major jump in the price of oil, the performance of the world economy in 1981 should show considerable improvement over the sorry record of 1980. Although the U.S. and European economies enter the new year on a note of weakness, by mid-summer, at least, the major industrialized nations are likely to be on an upward growth path. The pace of this advance will be relatively slow for the initial stages of recovery from a major world trade cycle, however, and the falloff in the overall rate of inflation will be disappointingly small. Heightened concern with the problems created by increased inflationary expectations has resulted in the adoption of relatively austere monetary policies in many countries. And a huge OPEC surplus will continue to provide a drag on the growth momentum of all oil-importing nations, developed and developing alike.

Projected economic growth in 1981 compared with 1980

(Change in real GNP: 4Q to 4Q)



This projection of sluggish recovery in the industrialized economies and relatively slow economic growth in the oil-importing developing countries assumes an increase in oil prices in 1981 of not much more than 20% above 1980, and nearly half of that increase has already been agreed to at the mid-December OPEC meeting in Bali. Given the uncertainties surrounding the Iraq-Iran war, no projection of oil prices can be offered with very much confidence. If exports from Iraq and Iran do not resume at significant levels in the second half of the year, maintenance of the balance between demand and supply could require even larger price increases. If so, the OPEC surplus would balloon to proportions that would threaten the industrialized economies' recovery from their present recession and dash the hopes of many oil-importing developing countries for continued per-capita income growth in the early 1980s.

Even if the rise in oil prices is held approximately to 20%, the OPEC surplus will remain extremely large this year—about $110-115 billion, much the same as in 1980. And the distribution of the deficits that are the counterpart to this surplus will weigh even more heavily on the oil-importing developing economies, whose combined current-account deficit will rise another $8 billion or so to a total of nearly $60 billion. The total deficit of the OECD countries is likely to fall by a corresponding amount. If even larger price rises and, hence, a larger OPEC surplus are forthcoming, the bulk of the increased deficits would accrue to the industrialized nations, as the limited ability of the oil-importing developing countries to increase their foreign borrowing would force them to cut non-oil imports sharply.

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WESTERN EUROPE

The European economies went into a synchronized downturn in mid-1980 and are now in a fairly severe recession. The weakening was induced by oil price hikes since 1979, intensified in many countries by restrictive policy responses. Average real economic growth in Europe last year was some 1.2%, compared with 3.5% in 1979. A consumption-led recovery is expected in the second half of 1981, but the upturn is likely to be both fragile and sluggish and will be insufficient to prevent a decline in 1981 real GDP of an estimated 0.3%, a projection with much downside risk.

Exceptionally restrictive domestic policies led the **British** economy into a deeper and earlier recession than most other European countries. The economy will bottom out in 1981 as inventory liquidation comes to an end and as rising real wages boost consumer demand. Even so, real GDP will fall further this year by perhaps 1½% after a record decline of 2¾% in 1980. The recession should, however, reduce the annual inflation rate to some 10% from the May 1980 peak of 21.9% and the current 15.3%.

Official growth projections in **France** are likely to prove optimistic. Real GDP growth last year is estimated at no more than 1.5%. In 1981, a consumer-led recovery will be offset by both weak investment and external demand, reducing the real GDP growth rate to 0.5%. The business slowdown will help lower the average annual rate of inflation from 12.3% last year to 11.2% in 1981. But higher oil prices will trim the current-account deficit only slightly, from 35 billion francs last year to some FF 25 billion.

Switzerland's economy posted real growth of 2.5% in 1980. Real GDP growth this year will be near zero, however, owing to weak external demand. Rising domestic costs will sustain last year's 4% annual average rate of inflation, but the current account—in deficit last year—should be held in rough balance in 1981.

In **West Germany,** a growing current-account deficit and rising U.S. interest rates have put pressure on the German mark and triggered a highly restrictive monetary stance. Consequently, real GDP, estimated to have expanded 1.8% last year, is expected to contract by about 0.6% in 1981. The rate of inflation, which peaked in mid-1980, is likely to fall over the course of 1981, with an average 4.6% rate of price increase expected for the year as a whole. Although recession and increased export competitiveness should cut the non-oil current-account deficit sharply, a higher oil bill will offset much of the gain.

Italy's economy is estimated to have grown by a real 3.3% last year. But the current recession is likely to last through mid-1981 and is expected to bring about a decline in real GDP of some 1.7% this year. Inflation, estimated at over 20% in 1980, is projected to fall to 16%-17% in 1981.

Europe's smaller economies will not escape recession. At best, they are expected to show no growth at all, although the **Scandinavian** countries, whose business cycles usually lag the rest of Europe, should enjoy moderate economic growth in 1981. Oil-blessed **Norway,** for example, may show real growth of some 1.5%. And **Finland** will be increasing its exports to the Soviet Union to pay for Soviet oil imports under the two countries' bilateral trade agreement.

WESTERN HEMISPHERE

Canada's prospects for 1981 are for a 2% real economic growth rate after a slight recession in 1980. Rates of inflation and unemployment, however, will remain above their current 10% and 7.5% respective levels.

Latin American growth this year is expected to decline slightly from the 5% estimated for 1980. The small downturn in the aggregate real GDP growth pace will be attributable mainly to policy-induced demand restraint in **Brazil.** Faced with 100%+ inflation and a current-account deficit of $13 billion, Brazil is pursuing restrictive fiscal, monetary, and wage measures to reduce growth, inflation, and import demand. In contrast, the **Mexican** economy will grow rapidly in 1981, at a 7.5% projected rate, the same as in 1980. Oil exports are fueling fast growth and aiding the balance of payments, but inflation is approaching the 30% level. **Argentina** should see its economic growth rate revive to about 3% in 1981, after a real GDP decline of 2% last year. Consumer price rises are likely to average 60% in 1981, well below the 100% of 1980.

In the Andean Group, **Venezuela** should post real growth of about 3% as the authorities reintroduce stimulative economic policies after two years of moderation; inflation may drop to 15%

as price decontrol tapers off and import liberalization continues. In **Ecuador,** economic growth should stabilize at about 4.5%, with inflation at 13%, as efforts intensify to develop oil resources. For **Colombia,** development spending will be constrained by inflationary pressures; a 5% real economic growth rate is likely, with a 25% rate of price rise. **Peru** is likely to record real economic growth of about 6% in 1981, but its inflation rate will range between 50% and 60%. In **Chile,** prospects are for 5% real economic growth and a rate of price increase in the 25%-30% range. Although **Paraguay's** economic growth is expected to quicken from the 8% rate recorded in 1980, **Uruguayan** economic activity is likely to slacken from its 4% growth pace of 1980.

The outlook for the majority of Central America is rather bleak. **El Salvador** and **Guatemala** are suffering in varying degrees from grave political upheaval. **Nicaragua** has rescheduled its debt to international commercial banks, but economic revival is blocked by a foreign-exchange scarcity and political uncertainty. And **Costa Rican** and **Honduran** authorities will have to slow their economies to contain external-payments disequilibria. **Panama** is the exception, with real economic growth of 5% expected in 1981, thanks to investment spending and earnings from services industries.

In the Caribbean, the pace of economic growth will quicken in **Trinidad** and **Tobago,** the **Bahamas,** and **Barbados.** The rest of the region will continue hindered by balance-of-payments disequilibria. Most notably, **Jamaica's** international reserves are negligible and its external debt totals $1.8 billion. The **Dominican Republic** should see some relief in 1981 from its present untenable external-payments position in light of strong sugar prices and normalization of output levels. **Puerto Rico's** economy will be hurt by the lagged effects of the U.S. downturn, but a recession should be averted because of contra-cyclical public policies.

ASIA-OCEANIA

Japan enters 1981 with moderate optimism, a tribute to its ability to withstand repeated oil price shocks. Real economic growth of about 5% is expected. Continued weakness in consumer spending, housing construction, and capital investment point to slow growth in the first half. But, barring unexpectedly large increases in labor and import costs, year-over-year inflation is expected to fall to some 5% by June. Consumer spending is then likely to accelerate, which should stimulate the economy in the second half. Despite an expected appreciation of the yen and renewed fears of protectionism, export price rises, combined with energy conservation measures and a second-half pick-up in the world economy, should bring about overall current-account balance this year, with a moderate deficit in the first half being offset by a small surplus for the July-December period.

In **South Korea,** positive real economic growth is expected this year, perhaps 4%-5%. Inflation will be high in the first half but may moderate toward yearend. Economic growth is slowing in **Hong Kong** and will not be much over 7% this year, owing to the OECD recession, but inflation should fall slightly from the current 15%. **Singapore's** role as an oil-industry service center ensures it strong economic growth in 1981. The 1979/80 oil price rise slowed **Taiwan's** inflation-adjusted economic growth rate to around 6% last year, and contributed to inflation of about 15% and a small current-account deficit. The economy is likely to show only slight improvement in 1981, unless OECD markets recover rapidly.

A real economic growth rate of 5%, inflation of 20%, and a current-account deficit of more than $2 billion are forecast for **Thailand** in 1981. The **Philippines** economy is not likely to improve much this year, as the prices of its main exports are declining. **Malaysian** real economic growth is projected at around 8%, with an inflation rate below 10%. The current account is likely to show a small surplus because of modest oil exports and continued strength of plantation export crops. **Indonesia's** economic growth should be on the order of 7%, with inflation forecast at 15%-20% and a current-account surplus of $2½-3 billion. And in **China,** continuing investment restrictions (part of a "readjustment" strategy), lower crop production during 1980, and slower growth in major export markets will restrain real economic expansion to 4%-5% in 1981 and boost the trade deficit over $2 billion.

Real economic growth of approximately 3% is forecast for **Australia** this year, but inflation is likely to remain near 10%. And **New Zealand's** inflation rate may slow to 14%-15%, with real economic growth remaining sluggish at 1%-1.5%.

MIDDLE EAST-AFRICA

Sharply higher oil prices widened the OPEC current-account surplus to between $110 billion and $115 billion in 1980. Prior to the outbreak of the Iraq-Iran war, a $25-30 billion narrowing in the surplus appeared likely for 1981. But the conflict could result in higher-than-previously-anticipated oil prices, and the 1981 OPEC surplus may not be much smaller than last year.

Saudi Arabia will account for a large share of this year's surplus, despite a high level of spending on military and civilian projects. And a limited absorptive capacity will expand **Kuwait's** current-account surplus sharply. Increased oil revenues and private-sector activity will accelerate economic growth in the **UAE** and **Qatar,** while **Oman** will be buoyed by a 25% jump in oil output. **Egypt's** trade deficit should widen in 1981 despite increased oil receipts, but the shortfall will be far more than offset by growing workers' remittances, Suez Canal revenue, earnings from tourism, and a pick-up in the disbursement of foreign aid. The **Tunisian** economy will grow rapidly this year, thanks to higher oil and phosphate prices, and **Morocco's** economy will be buoyed by phosphate export earnings and the availability of a three-year $1.1-billion IMF facility. If war persists, **Iran's** economy will be on its knees by summer without financial aid, while **Iraq's** economy boomed in 1980 and is likely to do so in 1981, despite reconstruction costs. **Jordan's** sound economy has been bolstered by Iraqi financial support, but **Syria** is unlikely to sustain its high-trend growth rate. And **Israeli** policy is expected to stay deflationary in 1981, which may improve the medium-term inflation outlook.

Oil exploration and output rose sharply in several **Sub-Saharan African** countries last year, while prices for many traditional exports declined. Oil-rich **Nigeria** recorded a $4.75-billion current-account surplus; it should post only a moderately lower surplus in 1981. **Gabon** and **Angola,** the only other African oil exporters, average sales of some 165,000 bpd; they could see current-account surpluses of $600-700 million in 1981. **Cameroon** will become a net oil exporter this year and should be able to reverse the recent deterioration in its current account. The **Ivory Coast** may export oil by 1983, but its 1981 current-account gap is likely to widen from last year's $1.5 billion if coffee and cocoa price weakness continues. **Zaire's** output of 20,000 bpd is providing some relief from rising oil costs, as is **Ghana's** 10,000 bpd. Oil finds in the **Sudan,** where several minor wells have been brought on stream, brighten an otherwise gloomy economic outlook, and exploration continues in several West African countries. **South Africa,** lacking oil, has made great headway in producing oil from coal; it may reduce import dependency to 12% of energy needs by 1983.

COMMODITIES

The outlook for world commodity prices this year is clouded by the Iran-Iraq conflict, as the strength of commodity demand, as well as rises in production costs, hinges largely on the path of oil prices. With sluggish growth in the industrialized nations, little improvement is likely for the already weak industrial commodity markets. But consumption of most agricultural commodities is expected to expand. And with world stocks trimmed by poor harvests last year, prices in many of these markets look set to rise.

Sales by the USSR could prompt temporary dips in the price of **gold** this year, but the primary longer-term influence on price will remain perceptions of progress in fighting inflation. Industrial demand for **silver** has declined substantially. This, combined with stepped up production, should sustain downward pressure on prices. And **platinum** demand is likely to remain soft because of the recession in the U.S. auto industry.

The slump in U.S. auto output is affecting the base metals as well. Slack demand for auto batteries is likely to keep **lead** prices low this year. **Copper** demand and prices remain weak but may recover if interest rates ease and spur some stock replenishing. **Tin** prices continue weak, increasing the likelihood of some price-support action by the International Tin Council, while a developing shortage of **zinc** concentrate could lend volatility to prices. High energy prices and weak cyclical demand have prompted some cutbacks in **aluminum** output; this could raise prices later in the year if shortages develop.

Two consecutive years of bad harvests in the Soviet Union combined with a serious drought in the United States have left many of the world's agricultural markets in their tightest supply situation in five years. Bumper crops of both **wheat** and **rice,** however, are expected in the 1980/81 harvest year. But with record consumption forecast, demand is likely to exceed the current year's output by a wide margin. **Feedgrain** supplies will be even tighter and high prices may force some adjustment in livestock production plans. **Pork** and **poultry** prices in 1981 will be significantly higher, on average, than in 1980. The outlook for **beef** prices is less clear. Most countries' cattle herds are being rebuilt; their marketing dates will depend on prevailing prices, feed costs, and general economic conditition.

Sugar prices appear likely to rise at least through midyear. Further drawdowns in world stocks are expected, despite the likelihood of small output increases in the current crop year. Large surpluses should sustain downward pressure on **coffee** and **cocoa** prices this year.

Tight supplies are expected to keep **cotton** prices firm in 1981, despite some sluggishness in world textile activity. And **rubber** demand could be bolstered if U.S. defense spending increases.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M_1)	exchange rate in U.S. dollars December 29, 1980	change from year earlier	current monetary conditions	
Argentina	Industrial constraints limit economic growth; wholesale inflation rate down to 60% annually.	May	+ 9%	102.1	$3,825	Aug.	9,458	+ 17%	13.3	0	Change in currency devaluation system boosts import costs.	Nov.	+ 89%	Aug.	+113%	.00051	—19%	Central bank funnels more funds to banks.	**Argentina**
Bahamas	Government fiscal budget posted a surplus in 1980.	June	+ 15%	1.1	4,590	Oct.	99	+ 11%	25.0	0	Net capital inflows declined in second quarter of 1980.	June	+ 11%	June	+ 10%	1.0100	+ 1%	Bank liquidity pressured by strong credit demands.	**Bahamas**
Brazil	Real GDP growth rate neared 8% in 1980, but slowdown is planned for 1981.	Oct.	+ 31%	204.7	1,725	Aug.	5,847	— 40%	2.8	0	Reserves drawn down by $3.5 billion for external payments.	Nov.	+113%	Oct.	+ 55%	.01605	—35%	Interest rates exceed 100% per annum.	**Brazil**
Chile	Major copper mining venture scrapped, casting doubt on goal of 50% output rise in 1980s.	Aug.	+ 24%	19.0	1,710	Oct.	2,930	+ 64%	6.1	128	Foreign-exchange controls liberalized; restrictions on foreign loans eased.	Oct.	+ 31%	June	+ 65%	.0260	0	Net foreign assets rising.	**Chile**
Colombia	Large capital expenditures planned or under way for electricity, steel, and coal.	Sept.	+ 24%	28.7	1,100	Oct.	4,672	+ 36%	11.0	0	Non-coffee exports represent over 50% of total.	Nov.	+ 26%	May	+ 28%	.0200	—12%	Peso loan availability is limited.	**Colombia**
Costa Rica	Tighter demand-management policies being implemented to ease import growth.	Aug.	+ 12%	3.9	1,790	Sept.	123	— 14%	1.1	57	Free market for foreign exchange expanded to include banking system.	Aug.	+ 19%	Aug.	+ 7%	.1200	0	Interest rates increased.	**Costa Rica**
Dominican Rep.	Export promotion law passed last year finally implemented.	Aug.	+ 19%	5.3	1,000	Oct.	178	— 7%	1.2	58	Normalization of sugar output and high prices will bolster 1981 payments.	June	+ 20%	July	+ 25%	Par	—	Liquidity is tight.	**Dominican Rep.**
Ecuador	Higher oil export earnings help offset lower output of certain farm crops.	Oct.	+ 12%	8.6	1,064	Aug.	935	+ 59%	4.9	0	Foreign investment on the rise.	Sept.	+ 14%	Oct.	+ 23%	.0380	— 5%	Credit demand shows seasonal increase.	**Ecuador**
Guatemala	Credit restrictions eased to stimulate the economy.	Dec. '79	+ 9%	6.9	975	Oct.	465	— 30%	3.7	0	Capital flight continues, with October reserves at $465 million.	Sept.	+ 10%	Aug.	+ 14%	Par	—	Bank reserve requirements lowered.	**Guatemala**
Honduras	Economic slowdown anticipated as authorities seek to stem balance-of-payments deterioration.	June	+ 9%	2.2	608	Aug.	169	0	2.0	21	Restrictions on exchange of C. American currencies to curb capital flight.	July	+ 21%	Aug.	+ 8%	.5005	0	Restrictive credit policy in place.	**Honduras**
Jamaica	Severe foreign-exchange crunch hindering economic activity.	June	+ 38%	2.7	1,250	Sept.	130	+ 19%	1.6	336	Talks with IMF resume; $570 mn. may be obtained over next 3 years.	May	+ 26%	July	+ 41%	.5700	+ 2%	Credit availability is limited.	**Jamaica**
Mexico	Economic growth rapid, despite capacity strains, shortages, and high inflation.	July	+ 83%	119.9	1,728	June	2,464	+ 27%	1.5	0	External debt exceeds $40 billion.	Sept.	+ 29%	Apr.	+ 26%	.0440	0	Demand for peso credit is strong.	**Mexico**
Panama	Economy expanding at a 5% pace, with construction spending up sharply.	Aug.	+ 22%	2.7	1,420	Sept.	109	— 22%	0.9	29	Colon Free Zone tonnage up 20% over 1979.	Aug.	+ 14%	June	+ 23%	Par	—	Credit is ample.	**Panama**
Paraguay	Inflation rate running below last year's level, owing to restrictive fiscal and monetary policies.	Aug.	— 16%	3.7	1,225	Oct.	743	+ 24%	15.6	0	Capital inflows are heavy.	Aug.	+ 18%	June	+ 16%	.00795	0	Local lending capabilities limited.	**Paraguay**
Peru	Tax incentives provided for industrial reinvestment; registration process streamlined.	June	+ 44%	13.0	752	July	1,845	+203%	10.3	545	Imports surge in response to liberalization measures.	May	+ 53%	May	+ 88%	.0035	—13%	Interest rate increases expected.	**Peru**
Puerto Rico	Delayed impact of U.S. recession causing slowdown in economic activity and employment.	Aug.	+ 3%	10.2	2,925	Aug.	8,405*	+ 9%	11.0	0	Tourism arrivals in 1980 were below those in 1979.	Sept.	+ 11%	Aug.	+ 2%	Par	—	Commercial loans increase moderately.	**Puerto Rico**
Uruguay	August inflation rate was 60%, down from 83% at end-1979, with further declines likely.	June	+ 16%	6.9	2,372	Aug.	499	+ 72%	3.8	0	Jan.-June exports up 16% from year earlier, but imports were up 95%.	Aug.	+ 60%	May	+ 27%	.1090	— 8%	Interest rates rise on dollar accounts.	**Uruguay**
Venezuela	Foreign firms may set up with 85% foreign capital, subject to 51% local ownership after 15 yrs.	June	+ 48%	48.9	3,619	Oct.	6,698	+ 20%	7.2	0	Wide range of tariffs lowered; many import license requirements removed.	Sept.	+ 22%	July	+ 13%	.2330	0	Interest rates increased.	**Venezuela**

*Commercial bank deposits

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World Interest Rates

market rates of Dec. 29, 1980; bond yields as of Dec. 26, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty-large banks 16.00	17.28	14.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.00	7.25
Day-to-Day Money	19.75 Dec. 30	21.00	13.6875	10.80	10.625*	8.00	17.625**	8.875*	0.50**	9.75
Treasury Bills 91-day, Middle Rates	14.10	17.15	13.0625	12.75	n. a.	n. a.	15.649** 73-day	no dealing	no market	5.875 2-month
Commercial Paper prime, 3-month, asked	15.00 finance paper	17.50 finance paper 15% tax w/h	12.95*	11.60 Certified	11.625* Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.25	17.50 15% tax w/h	14.1875	11.80 Certified	not traded	9.90	20.80**	no market	4.50**	no market
Government Bonds Long-term, new and old issues, average yield	11.78	13.00	13.29*	10.856 20% tax w/h	13.73*	8.76**	16.13**	10.51*	4.69**	8.963
Industrial Bonds prime, long-term, new and old issues, average yield	12.90 Aa Industrials	13.50	13.98*	14.24	14.65*	8.97**	16.34**	11.63*	5.875**	7.11
Bank Short-Term Rate to Best Borrowers (prime rate)	20.50	18.25	15.00*	15.75	13.85*	11.50	21.00 ⅛ quar'ly fee on outstdng.	11.00*	6.00**	7.50
Bank Time Deposits 3-month	16.50 Cert. of Dep.	16.75	14.625*	12.65	11.625*	10.05	10.75	9.50* large deposits	6.9375** residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	18.375	no market	15.00	no market	12.00	n. a.	no market	9.50	7.00	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8404	2.3700	.031661	.2208	.5122	.001081	.4689	.5648	.004820
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.475 *P*	3.297 *P*	5.773 *P*	5.802 *P*	8.221 *P*	1.114 *D*	8.536 *P*	10.906 *P*	8.337 *P*

Eurodollar Deposits
(London, interbank, bid)

Dec. 30	
7-day	19.875
1-month	18.125
3-month	17.5625
6-month	16.4375

International Arbitrage
(3-month, hedged) **+** *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	n.a.
U.S.-Canada Treasury Bills	−3.63
U.S.-Canada Finance Co. Paper	−3.735
Eurodollars-U.K. Local Auth. Deposits	n.a.

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.50
Over 7 yrs.	13.125
DM Bonds	
7 yrs. and under	9.00
Over 7 yrs.	9.25

Gold Price

London
afternoon fixing

593.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of Dec. 24; bond yields as of Dec. 19. ** Market rates as of Dec. 17; bond yields as of Dec. 12.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	12.6 (Nov.)	11.2 (Nov.)	15.3 (Nov.)	13.5 (Nov.)	5.5 (Dec.)	21.5 (Nov.)	4.2 (Nov.)	7.8 (Oct.)
Industrial production*	−2.5 (Nov.)	−2.2 (Oct.)	−9.5 (Oct.)	−3.0 (Oct.)	−3.2 (Oct.)	−2.9 (Oct.)	4.0 (Sept.)	4.8 (Oct.)
Trade balance† *(billions of local currency units)*	−$1.86 (Oct.)	C$0.69 (Oct.)	£0.45 (Nov.)	−FF5.90 (Nov.)	DM0.38 (Nov.)	Lit.2.340 (Oct.)	−SF0.51 (Nov.)	¥117 (Nov.)
Money supply (M_1)*	6.4 (Sept.)	7.9 (Oct.)	4.2 (Sept.)	9.1 (Aug.)	3.5 (Oct.)	17.3 (July)	−6.7 (Sept.)	4.3 (Sept.)
Velocity of money (M_1)*	3.4 (June)	10.7 (June)	11.7 (Mar.)	n.a.	5.8 (June)	4.3 (Mar.)	n.a.	5.7 (June)
Reserves minus gold *($ million, change from previous month)*	970 (Oct.)	−253 (Oct.)	−73 (Oct.)	858 (Oct.)	−2,553 (Oct.)	419 (Oct.)	2,364 (Oct.)	981 (Oct.)

* Percent change from 12 months earlier

† Figures are only for the month indicated

The U.S. Economic Outlook

Last year was a time of extremes for the U.S. economy. A recession in the first half of the year was one of the sharpest of the past four decades—but it was also the shortest on record. The rate of price inflation was extremely high early in the year, abated for a few months, and then rebounded. Interest rates reached record-high levels, then receded sharply, and then established even higher new records. The unemployment rate rose by about two percentage points, to a peak of 7.8%, and then drifted a bit lower.

For 1980 as a whole, total real Gross National Product was down modestly, by about 0.2%. But some industries suffered substantially. Sales of new automobiles fell by 15%, to about nine million units. On balance, all of the declines came in domestic models; sales of small, fuel-efficient imported cars remained strong. Construction was started on only 1.3 million new housing units—about 25% less than in 1979, which was itself an unsatisfactory year for homebuilding. Industries that supply the automotive and construction industries have thus had extremely weak years.

The new year opens on a note of weakness, as did 1980. Consumer spending leveled off late last year, in real terms, under pressure of rapid inflation and sky-high interest rates. Residential real estate activity began declining again, as a consequence of high interest rates. And with Social Security taxes having risen on January 1, it seems to many experts that another period of economic decline may be at hand. However, most expect it to be both brief and mild. Lower interest rates, a somewhat lower inflation rate, and an expected cut in both individual income taxes and business taxes could bring a broad-based and more sustained advance in economic activity by the beginning of the summer. On balance, average real GNP in 1981 will be up little, if any, from 1980, although a gain of about 1½% is expected on a fourth-quarter to fourth-quarter basis.

Inflation continues to be a deep-seated and persistent problem for the U.S. economy. Some elements in recent rapid price increases, to be sure, may be transitory. The process of decontrolling the prices of domestic crude oil, for example, is giving the United States an even faster advance in the cost of petroleum-based products than that experienced elsewhere in the world. (The decontrol process is to be completed by this October.) And disappointing crops in 1980 have stimulated consumer food prices; these will rise by 15%-20% between mid-1980 and mid-1981. Better crops this year, if they materialize, could bring some relief to food prices later in 1981. In consequence, the rate of price inflation may improve as the year passes. But beneath such special factors, the United States has an underlying inflation rate of 9%-10%, as measured by rising unit labor costs in the face of poor productivity.

The new administration and Congress may well feel that the recent elections give them a mandate to deal more firmly with inflation. Policies to this end will include efforts to reduce the cost of government regulations, tax changes designed to stimulate saving and investment, and, most important of all, attempts to cut back the fast rise in non-defense federal spending and lending programs. Of these policy goals, the most difficult to fulfill will be the reduction in non-defense spending. Many of the programs involved are designed to grow automatically at least as fast as inflation. And the beneficiaries of these programs have by now become accustomed to their benefits. Even if progress is made toward these objectives, however, no significant decline in the inflation rate is likely in 1981. Consumer prices are forecast to rise about 11% from fourth-quarter 1980 to fourth-quarter 1981, compared with 12% from 1979 to 1980.

Lower interest rates likely

Short-term interest rates are expected to fall in the first half of 1981—although not as low as they fell last spring. With stronger money demand as the economy recovers—and assuming the Federal Reserve holds to its money growth targets—rates should move considerably higher after midyear. The federal funds rate, for example, is likely to average 13%-14% for 1981 as a whole, about the same as in 1980.

One of the central elements of the 1980 financial environment was the Federal Reserve's implementation of a policy of placing greater emphasis on achieving money growth objectives and less on stabilizing interest rates. Many observers have attributed to the Federal Reserve a desire to achieve almost complete control over the growth of the monetary aggregates. But so far, the Fed has not intended to do so. Indeed, there are currently a number of operating problems that virtually ensure that it cannot do so.

Despite the caveats, however, the outlook for money growth provides a perspective by which to assess at least the direction, if not the exact magnitude, of interest-rate moves in 1981. This approach may be illustrated by using M1-B as the relevant monetary aggregate. In recent years, the trend growth rate of money turnover (velocity) has approximated 3½%. The Federal Reserve's indicated maximum target for M1-B growth during 1981 is 6%. This suggests that nominal (current-dollar) GNP could advance by as much as 9½% (the product of money growth and turnover) without entailing above-target money growth and the attendant upward pressure on interest rates. This formulation, however, is subject to considerable error from quarter to quarter.

The basic dilemma facing the Federal Reserve and

The U.S. Economic Outlook

(continued from page 7)

other economic policymakers is that a 6% money growth maximum provides little room for real growth in 1981 as long as the underlying inflation rate is in the 9%-10% range. With a weaker economy in the early part of the year, the money growth constraint should not be binding and interest rates are likely to fall. Nonetheless, during this period nominal GNP will be advancing at an annual rate approximating 8%, and money growth will probably be well within the Fed's target range. Thus, any downward rate correction is expected to be moderate. This contrasts with the second quarter of 1980, when nominal GNP was flat and money growth fell below the Fed's target range, precipitating a sharp rate decline.

A second-half recovery, however, is likely to entail nominal GNP growth well above 10%, on an annual basis. This will place relatively pronounced pressures on the Federal Reserve's money growth targets.

Three additional elements have an important bearing on the money-growth and interest-rate outlook. First, the introduction of new transaction accounts on a nationwide basis (e.g., NOW accounts) will alter the growth path of such narrower aggregates as M1-B. Some redefinition of targets and changes in relative emphasis, such as between M1-B and M2, are thus likely. Second, the level of interest rates relative to inflation will affect the performance of the economy as well as expectations. In the closing months of 1980, interest rates were quite high relative to inflation. This drag on the economy will carry into first-quarter 1981 and probably re-emerge later in the year. Third, the prospect of financing a federal deficit of some $50 billion casts further doubt on the likelihood of much relief from high interest rates.

Finally, the outlook for business financing in 1981 is for moderate increases in capital expenditures (as well as inventories) and sluggish growth of cash flow. The financing gap for nonfinancial corporations is thus projected to be slightly above that of 1980. Moreover, firms are expected to continue the buildup of short-term liquid assets that began in the third quarter of 1980. The volume of credit-market financing in 1981 is therefore expected to be somewhat above 1980, contributing some pressure on interest rates.

U.S. current-account outlook

Last year was another banner year for U.S. exporters. Following the 28% growth in exports during 1979, 1980 registered a strong increase of slightly less magnitude. Were it not for huge oil price shocks, the U.S. trade deficit would have narrowed dramatically, as the growth rate of non-oil imports was slower than the rate of inflation. But with oil prices for the fourth quarter of 1980 some 33% above fourth-quarter 1979 levels, the overall trade gap was narrowed by only some $4-5 billion. This limited improvement, combined with the continued earnings growth in the services account, was sufficient to give the United States its first current-account surplus in four years. The U.S. surplus was all the more notable as it was achieved at the same time that Japan, Germany, and other traditional-surplus countries sustained massive current-account deficits.

The U.S. current account may continue its long climb back to solid surplus this year, the result largely of a renewed U.S. recession. But OPEC pricing policies, the severity (and timing) of economic slowdown in Europe, weak demand for exports by the deficit-ridden non-oil developing nations, the possibility of renewed U.S. import demand, and a leveling-off of the services surplus could exert a strong negative impact in the second half of the year.

Total export growth for 1981 is projected to decline to between 9% and 15%. Agricultural exports are expected to provide momentum, but non-agricultural exports, which advanced sharply in 1980, are expected to lag in 1981. They will be hurt badly by the slowdown in foreign economic activity, which could be further exacerbated by greater oil shocks.

Import prospects continue to be heavily dependent on the uncertain oil price scenario. Total imports are forecast to expand by 14%-15%, largely a result of anticipated oil price rises. U.S. oil import costs in 1981 are projected to exceed $100 billion, up some 20% from 1980, while nominal non-oil imports are expected to rise by only about 9%—below the forecast inflation rate. The United States will essentially be paying for more expensive energy by curtailing non-oil imports. Although the United States was able to reduce oil imports substantially in 1980, it will be extremely difficult to reduce import volume further this year.

In sum, the U.S. external-account outlook for 1981 is highly uncertain. Reduced levels of real economic growth around the world will dampen trade activity for all trading nations in 1981, dimming prospects for both export and import growth in the United States. Still, the possibility of another large merchandise trade deficit in 1981 means that the United States will again rely on services earnings to bolster its current account. And indeed, earnings from direct investments abroad, as well as receipts from such other services as transportation and insurance, should improve. The pace, however, will be slower this year than in 1980, in view of the expected weakness in foreign economic activity.

With so many imponderables on the horizon, projecting a U.S. current-account balance for 1981 is highly speculative. The current account could range anywhere between a deficit of $8 billion and a surplus of $6 billion, much depending on the oil-import outcome. The most likely scenario, however, is for a 1981 U.S. current account in near balance.

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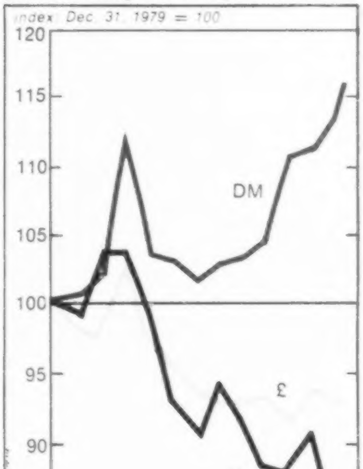
The Outlook For the Dollar

The dollar's strength over the past several months clearly reflects the unusually high differentials between interest rates in dollar markets and the money markets of other major currencies. These differentials are expected to diminish, and the dollar is expected to weaken as U.S. interest rates recede. There is little agreement, however, as to the timing or magnitude of this decline—or the potential for subsequent recovery. As a result, the exchange markets have been very nervous, with significant volatility in rates on a day-to-day basis.

In considering these uncertainties several points are worth stressing. First, given the outlook for small to moderate change in the current-account positions of the major economies, exchange-rate movements this year are likely to continue to be dominated by changes in interest-rate differentials. Second, the likely fall in U.S. interest rates in the first half of the year, although deep, is unlikely to match the decline of last spring. The prospective weakness of the U.S. economy in early 1981 shows no signs of coming close to the free-fall experienced in the second quarter of 1980. Third, upward pressure on U.S. interest rates is likely to develop in the second half of the year. The economic growth recovery projected for that period implies an acceleration in the demand for money and credit, and there is no reason at this time to doubt the Federal Reserve's commitment to restraining inflationary expectations by keeping monetary growth under control.

The outlook for the dollar implied by this view of the major elements underlying exchange markets is for moderate weakness over much of the first half of the year followed by recovery. The swings in key rates over the course of the year should show somewhat less amplitude than in the year just past even if no significant change is presumed in the Federal Reserve's operating procedures. In terms of trade-weighted indexes, as in 1980, the foreign-exchange value of the dollar at yearend 1981 could well show a modest improvement over its level at the beginning of the year. There is, however, one major caveat in the outlook: that the exchange markets do not come to perceive the net budgetary implications of the fiscal strategy adopted by the Reagan Administration as inconsistent with the continuation of the Federal Reserve's current strategy. In such an event, an extended period of dollar weakness would ensue.

Shifts in the
U.S. dollar's value
(units of foreign exchange/dollar)*



*end-of-month, except for January 1981

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Italian recession continues, with real GDP decline seen for 1981.

Italy's economy contracted sharply last summer with third-quarter real GDP declining at a seasonally adjusted annual rate of 10%. Although the economy apparently stabilized in September and October, leading indicators still point downward, and year-over-year inflation remains above 20%. All in all, real GDP growth in 1980 is unlikely to have exceeded 3.5%. The Forlani government recently reinstated gasoline price rises, doubled the automobile tax, and postponed income tax reductions for the lowest paid. The $2.6 billion that these measures hope to net is earmarked as aid to the earthquake zone. With the recession expected to continue at least through the first quarter of 1981--and probably through the first half--fiscal reflation can be expected, which should spur economic recovery in the latter part of the year. Even so, the negative carryover from 1980 will mean that real GDP in 1981 as a whole will likely decline by 1%-2%.

Spanish economy weakened in 1980; little hope of recovery in 1981.

Last year marked a watershed for the Spanish economy. Real economic growth slowed to an estimated 0.5%, and the current account shifted into deficit by $4.8 billion after posting a surplus of $1.2 billion in 1979. The year-average inflation rate in 1980 was 15.5%, and the peseta declined in value by more than 11% in effective terms. Moreover, unemployment now exceeds 12% of the labor force. This year offers little hope of substantial improvement in view of renewed oil price hikes, depressed export markets, and the prospect of another large public-sector deficit. Economic growth may recover slightly, to a rate of about 1%. But with the expectation of at least a $2-billion increase in the oil-import bill, it is difficult to envisage a current-account gap of much less than $5 billion. This implies that the Spanish will continue to be active borrowers in the international capital market.

Greek economic growth was flat in 1980; only moderate improvement forecast this year.

Short-term economic prospects for Greece—the European Community's newest member—are mixed. Rising inflation and a widening balance-of-payments deficit prompted the authorities to tighten economic policy in early 1980. As a result, industrial output declined sharply around midyear and import growth slackened, trimming the current-account deficit for the January-October period to $1.44 billion, as against $1.54 billion in the year-earlier period. The domestic economy, however, is estimated to have shown no real growth last year, and the yearend inflation rate remained above 24%. More worrisome is the 27% growth in manufacturing wages in the first half of 1980. An end to inventory liquidation and a reflationary 1981 budget should bring about real economic growth of some 1.5%-2.0% this year, but only at the cost of little easing of inflation and a widening in the current-account deficit to about $2.2 billion-2.4 billion.

Canada signals economic recovery, but its strength is likely to be minimal.

Canadian real GNP increased at a 1.6% annual rate in the third quarter of 1980, after two quarters of contraction, raising hopes of an end to recession. Industrial output rose 0.6% from September to October, with manufacturing orders up 1.5% over the same period. And the unemployment rate dipped to 7.3% in November from 7.6% in the preceding month. The pick-up in economic activity has been fueled largely by a sharp rise in exports. These developments point to positive real economic growth this year, but the recovery is unlikely to be strong. Interest rates are high—in response to U.S. rate levels—and may dampen investment and housing this year. Furthermore, the year-over-year rate of inflation has accelerated, rising to 11.2% in November from 10.9% in October. And slow growth for the world economy in 1981 will likely constrain further large export gains.

Foreign investment in Mexico soared last year.

Foreign investment in Mexico during 1980 is likely to have set a record, despite continuing stringent limits on the share of foreign equity ownership. New foreign direct investment in the first half of last year totaled $784 million, compared with some $280 million in the year-earlier period and with an annual average of $590 million for the period 1973-79. The stock of foreign investment has also risen dramatically. Most recent data—for the year 1978—put total outstanding investment at $4.7 billion, up 45% from 1976 when investment dropped in the wake of a large peso devaluation. Of the total outstanding investment, about 70%

is held by U.S. companies, and nearly 80% of all investment is in the industrial sector. It is in this sector—especially in auto parts and petrochemicals—that investment is expected to grow most rapidly in 1981.

Japan achieves impressive results in reducing inflation.

Japan appears to be winning the battle on inflation. The rate of wholesale price increase declined from its April peak of 24% to a year-over-year rate of 11.8% in November, and consumer price rises eased from their peak of 8.9% in August to 8.4%. The forecast for fiscal 1981-82, beginning in March, is for wholesale price inflation of only 4% and consumer price inflation of 5%, down sharply from the current fiscal year's estimated 14% and 8.5%, respectively. The reasons for the recent easing of inflationary pressures and for the bullish outlook are relatively moderate oil price increases, a restrictive monetary policy that has dampened inflationary expectations, and yen appreciation. Moreover, overall economic prospects are favorable, as the impending labor contract negotiations are expected to yield nominal wage increases of some 7%-8%, coincidental with productivity growth of about 7%. The resulting real wage rises are thus likely to boost consumer spending, which should lead the anticipated Japanese economic recovery.

Bahrain's economy signalling recovery.

The Bahraini economy's seesawing of the last half decade has been characterized by overheating in 1976-78, slowdown in 1979, and more recently, gradual recovery. Government capital expenditures, so critical to overall economic activity, have been restored to their 1978 level after a 35% cut in 1979. At the same time, higher oil prices and dampened import demand have offset declining oil output and shifted the current account into surplus in 1980—the first surplus in over a decade. The impact of higher oil revenues on the domestic economy has been limited, however, as the authorities have sought to contain inflationary pressures. Prospects for 1981 and beyond appear encouraging as the business community has overcome regional political uncertainties to a large degree. The $1-billion causeway to Saudi Arabia is scheduled to begin construction before the end of the year, which will entail significant spillover for the domestic economy. And Bahrain's industrial base continues to expand, with new aluminum, petrochemical, and iron-pelletizing projects about to be implemented.

Copper prices likely to remain soft in face of weak demand and inventory build-up.

Copper prices are unlikely to rise much above their present levels in 1981 because of weak demand and high production levels. World demand for copper is expected to be relatively flat this year as high interest rates and economic recession dampen auto sales and housing construction in the United States. European and Japanese demand will be similarly weak, owing to slowdowns in industrial output and overall economic growth. Although world copper demand is only expected to grow by between zero and 1% in 1981, production appears likely to rise by more than 5%. As a result, inventories will be built up in 1981—for the first time since 1977—to an estimated level of 1.4 million metric tons, 29% higher than in 1980, but still below the 1977 level of 2 million tons. With copper prices now roughly equivalent to the variable cost of production, approximately 80¢ per pound, and the anticipation of a build-up in producer inventories, prices are expected to remain about where they are now for much of 1981.

Export credit agreement's future uncertain.

The Arrangement on Export Credits adhered to by 22 OECD-member nations was dealt a potentially fatal blow in Paris last month. The informal accord—implemented in April 1978—sets minimum interest rates and maximum repayment terms for government-backed export credits. Although the rate minimums were boosted in July (to 7.75%-8.75% for over-5-year credits), they are still far below market levels, entailing heavy subsidies for countries willing to lend at the minimums. The United States has spearheaded the effort to boost rates and key them to money market movements, but opposition from within the European Community deadlocked the most recent negotiations. It now remains to be seen how rigorously the U.S. policy of violating the Arrangement's maturity limits is carried out and whether it precipitates other violations. Optimists are hoping for a consensus at the next scheduled meeting in May.

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Sales Dip Portends Renewed Downturn

Statistics on the yearend buying behavior of American consumers offer the first concrete sign that the U.S. economy may once again be weakening. Department of Commerce figures released last week showed a dramatic and unexpected 1.3% decline in the seasonally adjusted value of monthly retail sales in December. This was in sharp contrast to the hefty 1.6% increase recorded in November and marked the first drop in retail trade since last May. The direction of the change—and its magnitude—caught the financial markets off guard, but lent support to the suspicions voiced by a number of economists in recent weeks that the economy is poised for a renewed downturn.

The end-of-year runup in interest rates strongly inhibited consumers' durable-goods purchases, particularly in the automotive sector where sales plunged 7.4%. This was clearly the dominant influence in the decline of the total sales figure, as sales of nondurables—extremely weak despite a surge of last minute Christmas shopping at department stores—remained essentially unchanged from November levels. Adjustment for price increases during December indicates that retailers suffered an even more severe falloff in sales volume.

Whether the latest retail trade report truly augurs the beginning of another recessionary dip in the economy remains to be seen. One month's statistics by no means establish a trend. Indeed, the initially announced estimates of one month's retail sales are based on a small sample of early reports from retailers, and are almost always revised in subsequent months as more information becomes available. And sometimes those revisions are substantial. Moreover, the Federal Reserve reported last week that industrial production rose 1.0% in December, suggesting continued real growth in the economy. If the retail sales numbers are borne out, however, the industrial output figure points to the possibility that some unwanted accumulation of business inventories may have occurred. And with interest rates still high, this would presage production cutbacks in the coming months if consumer spending remains weak.

There is, however, corroborating evidence to support the economic significance of the December retail sales figures. For one thing, the striking decline in the money supply in December reinforces the Commerce Department's report that retail spending was off during that month. In addition, indexes of how consumers regard the future showed consumer confidence down sharply in the final month of 1980, after six months of increases, and that buying plans were being postponed for autos, houses, major appliances, and vacations.

The recent statistics on consumer credit also support the view that consumer spending has been cautious. Consumer credit outstanding increased at an annual rate of only 3% in both October and November, according to another government report released last week. Preliminary indications suggest a modest rise in December as well. This contrasts with an annual growth rate in personal income for the last three months of about 13%. These data indicate that consumers have continued to reduce the burden of their debt and imply a reluctance to incur additional debt to finance consumption.

The evidence supporting weakness in spending may prove significant in determining the future course of monetary policy and interest rates. While the money supply fell sharply from mid-November to late December—M1-B (currency plus checkable deposits) declined at an annual rate of about 8½% in December—there was skepticism on the part of analysts as to whether this drop signalled anything about the economy, or was merely a statistical aberration soon to be reversed. The decline in retail sales, however, has reinforced the notion that the recent drop in money growth was indeed "real." This in turn has heightened the market's perception that interest rates will move down further in coming months.

The Federal Reserve is certain to have taken careful note of the retail sales figures. A number of members of the Federal Reserve's Board of Governors have been skeptical of consensus forecasts that the economy was or would soon be weakening—especially given the poor forecasting performance of the economics profession in general and of the Board staff in particular. Thus, in making policy decisions, the Board has tended to place greater weight on recent history than on forecasts. In this regard, as noted earlier, the December retail sales figures offer the most solid evidence to date that such weakness may have arrived, especially when combined with the recent behavior of the money supply. It may take more than one month's figures, however, to convince monetary policymakers that a sustained economic slowdown has begun.

If consumer spending does remain weak in coming months, there should be a concomitant depressing effect on the economy as well as on the demand for money and credit. This in turn would put significant downward pressure on interest rates. And in the face of declining interest rates consumer spending may be stimulated. Still, there are other economic influences—such as continued high inflation, increasing energy costs, higher social security taxes, and bearish real wage prospects—that may prevent any consumer spending revival strong enough to support more than a listless economic recovery.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
			6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars January 14, 1981	change from year earlier	current monetary conditions	
Africa	**Algeria**	Budget for 1981 projects oil revenue of $12.2 billion, up 45% from 1980.	Sept.	+ 50%	24.6*	$1,374	Nov.	3,632	+ 64%	5.1	0	Agreement with British Gas Corp. on LNG export price of $4.60/million BTU.	Dec. '79	+ 12%	Dec.'79	+ 18%	.2550	+ 26%	European Investment Bank lends $26 mn. for power projects.	**Algeria**
	Congo	Increasing oil output and liberalized investment code encourage Western business.	Dec. '78	+ 15%	0.1*	635	July	90	+ 718%	4.5	9	Higher oil receipts in 1980 likely to have produced small payments surplus.	Apr.	+ 8%	July	+ 46%	.004436	— 10%	Payments on arrears and for imports improve.	**Congo**
	Egypt	Sharp rise in export revenues underlies continued economic growth and enlarged payments surplus.	June	+ 74%	16.4	400	Sept.	1,117	+ 247%	3.4	226	Suez Canal expansion scheme completed; 1981 revenue of $1 billion expected.	July	+ 26%	Sept.	+ 25%	1.4360	— 1%	Bank credit to public sector growing more slowly.	**Egypt**
	Ethiopia	New guidelines on investment by foreign firms and on joint ventures to be announced.	June	+ 16%	3.1	105	Oct.	124	— 18%	2.1	47	Drop in coffee's share of exports shows progress in export diversification.	Aug.	+ 2%	Apr.	+ 16%	.4870	+ 1%	Total reserves fell sharply in November.	**Ethiopia**
	Ghana	Widespread product shortages persist in face of government's belt-tightening measures.	Dec.	+ 8%	4.3*	386	Nov.	223	— 20%	2.9	63	Import restraint holding external accounts in surplus.	July	+ 68%	Aug.	+ 38%	.3640	—	IMF credit of $130 million under negotiation.	**Ghana**
	Kenya	Stiffer import controls certain to dampen economic growth.	June	+ 39%	6.0	400	Nov.	502	— 21%	3.4	168	Issue of import licenses and foreign-exchange control approvals tightened.	Sept.	+ 12%	May	+ 18%	.1405	— 3%	Bank of Oman to open branches.	**Kenya**
	Morocco	Contract awarded for a $176-million steel plant at Nador.	June	+ 46%	15.3	788	Oct.	205	— 43%	0.6	341	Higher prices boost phosphate export revenues.	Aug.	+ 10%	Sept.	+ 10%	.2390	— 11%	A $170-million Euroloan finalized for phosphate projects.	**Morocco**
	Nigeria	Agriculture and industry (especially iron and steel) given priority in 1981 capital budget.	Aug.	+ 56%	50.7	625	Oct.	10,232	+ 132%	10.8	0	Export diversification lags; oil still accounts for 95% of total receipts.	Mar.	+ 12%	June	+ 15%	1.9200	— 6%	Loanable funds for industry increased.	**Nigeria**
	Senegal	Real GDP likely to have contracted in 1980, owing to austerity and groundnut crop failure.	Dec.	— 9%	2.2*	407	Sept.	10	— 58%	0.1	75	Lower export receipts widened 1980 current-account gap to $400 million.	Sept.	+ 6%	May	— 4%	.004436	— 10%	Large aid inflows from France continue.	**Senegal**
	Sudan	Agricultural output expected to rise, spurred by expanding cotton and sugar production and rains.	June	+ 113%	9.1	508	Nov.	82	+ 1%	3.3	358	Current-account deficit in 1981 likely to match last year's $950 million.	June	+ 32%	Sept.	+ 27%	2.0140	— 1%	Payments arrears estimated at $1.3 billion.	**Sudan**
	Tanzania	Producer price rises and involvement in Uganda widen budgetary deficit.	Dec.	+ 9%	4.6	267	Oct.	48	— 16%	0.5	132	Drop in coffee and cocoa prices widens trade gap.	June	+ 28%	May	+ 33%	.1235	+ 1%	Credit tightly controlled.	**Tanzania**
	Tunisia	Government plans to double phosphate output in the 1980s.	June	+ 38%	7.0	1,096	Nov.	706	+ 13%	2.8	0	Exports up 42% in first seven months of 1980.	Sept.	+ 9%	Sept:	+ 18%	2.4675	— 2%	Arab Fund lends $12.8 million for irrigation project.	**Tunisia**
	Zambia	Low copper prices and rising costs dampen incentives for capacity expansion.	Dec.	— 4%	3.2	572	Oct.	51	— 55%	0.6	423	Current account swung into deficit of $235 million last year.	June	+ 14%	July	+ 14%	1.3200	— 3%	Decline in foreign-exchange holdings continues.	**Zambia**
Middle East	**Iraq**	War causing fuel shortages, but stocks of food and other consumer goods reported ample.	Sept.	+ 61%	23.3*	1,875	n.a	—	—	—	0	Oil exports by pipeline via Turkey and Syria not yet resumed.	Sept.'79	+ 8%	n.a.	—	3.4015	—	Credit generally available.	**Iraq**
	Kuwait	Official cost-of-living index rose at a 10% annual rate in first-half 1980, versus 5% year earlier.	Sept.	— 2%	23.3**	18,330	Nov.	3,982†	+ 47%	9.2	0	Oil price reportedly raised 12.7% to $35.50 per barrel.	Mar.	+ 8%	Sept.‡	+ 10%	3.6860	—	Money supply expanding steadily.	**Kuwait**
	Qatar	A $675-million petrochemical complex came on-stream in late December.	Sept.	+ 44%	4.5*	22,500	June	346†	n.a.	—	0	Oil price reportedly raised 12% to $37.42 per barrel.	n.a.	—	June‡	+ 18%	.2750	+ 1%	Money supply growing more rapidly.	**Qatar**
	Saudi Arabia	Several contracts awarded foreign firms and joint ventures in education, health, and infrastructure.	Sept.	+ 76%	74.8***	11,510	Nov.	24,616†	+ 33%	12.3	0	Oil price boosted $2 per barrel to $32, retroactive to November 1.	Mar.	+ 2%	June‡	+ 36%	.3005	— 1%	Money supply growth accelerates.	**Saudi Arabia**
	United Arab Emirates	Abu Dhabi undertaking major new oil and gas exploration projects.	Sept.	+ 47%	13.8*	19,435	Nov.	1,950†	+ 78%	3.7	0	Abu Dhabi cut oil production ceiling by 80,000 bpd, or 6.3%, in January.	n.a.	—	Sept.	+ 21%	.2725	— 2%	Federal Real Estate Bank capitalized at $545 million.	**United Arab Emirates**

1978 FY 1979/80 FY 1978/79 †Excluding state reserves ‡Private sector only

World Interest Rates

market rates of Jan. 14, 1981; bond yields as of Jan. 9, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty-large banks 16.00	17.00	14.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.00	7.25
Day-to-Day Money	19.00 Jan. 15	17.50	13.50*	7.75	10.875	9.15	17.50	9.125	1.50	9.0625
Treasury Bills 91-day, Middle Rates	15.03	16.70	12.9375*	12.50	n. a.	n. a.	14.50 76-day	no dealing	no market	5.875 2-month
Commercial Paper prime, 3-month, asked	16.50 finance paper	16.25 finance paper 15% tax w/h	12.76*	11.80 Certified	11.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.75	16.65 15% tax w/h	13.75*	11.80 Certified	not traded	9.90	20.35	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	11.84	12.625	13.63	10.465 20% tax w/h	13.77	8.98	16.18	10.25	4.66	8.622
Industrial Bonds prime, long-term, new and old issues, average yield	12.75 Aa Industrials	13.625	14.22	14.97	14.68	9.06	16.43	11.51	5.74	7.14
Bank Short-Term Rate to Best Borrowers (prime rate)	20.00	17.75	15.00*	15.75	13.85	11.50	21.00 ⅛ quar'ly fee on outstdng.	11.00	6.00	7.50
Bank Time Deposits 3-month	16.50 Cert. of Dep.	16.00	14.50*	12.35	11.625	9.25	10.75	9.625 large deposits	5.5625 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	18.5625	no market	14.50	no market	11.500	9.1250	no market	9.50	5.4375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8390	2.4025	.0310	.2170	.5025	.001055	.4620	.5546	.004929
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	1.50 *P*	4.00 *P*	6.25 *P*	7.00 *P*	9.00 *P*	.875 *P*	9.00 *P*	12.25 *P*	9.875 *P*

Eurodollar Deposits
(London, interbank, bid)
Jan. 15

7-day	19.875
1-month	19.8125
3-month	18.75
6-month	17.125

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	n.a.
U.S.-Canada Treasury Bills	−2.29
U.S.-Canada Finance Co. Paper	−1.02
Eurodollars-U.K. Local Auth. Deposits	n.a.

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.75
Over 7 yrs.	13.50
DM Bonds	
7 yrs. and under	9.25
Over 7 yrs.	9.375

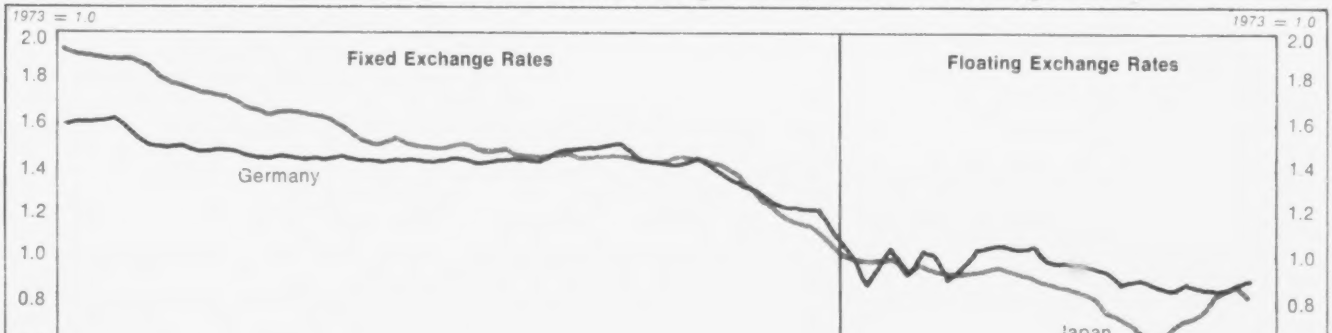
Gold Price
London
afternoon fixing

556.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of Jan. 7.

Exchange value of a U.S. basket of goods ("real" exchange rate)



Exchange Rates and PPP: Words of Caution

Perhaps the single most popular guide to foreign-exchange forecasting, especially over long periods of time, has been the theory of Purchasing-Power Parity (PPP). This venerable doctrine, linking currency values to domestic price levels, has been employed in recent modern theories of rational expectations and international monetary adjustment, serving as a rather sophisticated and presumably powerful approach to the analysis and forecasting of exchange-rate movements (see *International Finance*, July 23, 1979, page 8). Useful as PPP may be as a very *general* guide, however, as a forecasting tool it is flawed. Recent empirical research indicates that even in the long run, PPP may not be as strong a theory as many forecasters would like to believe.

According to PPP, the exchange value of a currency is closely linked to its domestic purchasing power. The "absolute" version of the doctrine implies that, apart from short-run fluctuations, the exchange rate between the currencies of any two countries will equal the ratio of the two nations' price levels. That is, when the exchange value of sterling is, for example, $2.40 in U.S. dollars, then a standard basket of goods worth £100 in Britain costs $240 in the United States. While few economists would expect this relationship to hold in the short run, many believe it is a reasonable guide to currency prices in the long run.

A potentially more useful formulation of PPP for forecasting purposes is the "relative" version of the hypothesis, which states that the percentage *change* in the exchange rate should equal the difference in the rates of inflation between the two countries. If, for example, British prices rise 15% in a given year while U.S. prices increase by just 10%, then the relative purchasing power of the two countries' currencies would be preserved only if sterling lost 5% of its dollar value during the year—falling, say, from $2.40 to $2.28. At the new exchange rate of $2.28, the British and American baskets could still be exchanged on a one-for-one basis. That is, the "real" exchange rate between the two countries—the exchange value in terms of goods—remains constant when relative purchasing-power parity is maintained.

The relative version of PPP offers a simple guide for exchange-rate forecasting. Over the long run, currencies adjust in relative value to offset differential rates of inflation so that the trend level of the real exchange rate does not vary over time.

Although this hypothesis is generally accepted in the economics profession, empirical research conducted in the Chase Economics Group casts doubt on the validity of PPP, even in the long run. To test the doctrine statistically, the exchange value of a U.S. basket of goods—for an appropriate basket of the goods of other countries—was set at 1.0 for an arbitrary base year. If the hypothesis were strictly true, then this "real exchange rate" would show only short-run fluctuations, centered on 1.0, over a number of years. But this was not borne out by the statistical tests. Data were examined for the real exchange rates of several countries for two periods: the fixed-rate years of 1960 through early 1973, and the subsequent period of managed floating exchange rates. Contrary to relative PPP, the evidence suggests that the real exchange value of U.S. goods was not constant over time in either period.

The results for two countries, Germany and Japan, are shown in the chart at the bottom of page 6. Real exchange rates were calculated by deflating the U.S. Consumer Price Index by the CPI of the country in question and the dollar price of its currency. The price indexes and exchange rates were converted to a common base year of 1973 (the year of change from fixed to floating rates), and the real exchange rate was set at 1.0 for the base year. As the chart indicates, the real exchange value of U.S. goods for Japanese goods fell fairly steadily during the period 1960-73, losing almost half its worth. It has continued to fall since that time. Similar, although less striking, results are shown for Germany in both periods. Numerically, the U.S. real exchange rate drifted downward at a rate of 3.6% per year against Germany and 6.0% a year against Japan during the fixed-rate period. Statistical analysis confirms the impression given by the chart: There has been a long-term decline of the real exchange rate of the United States with respect to several countries, including Germany and Japan. These results thus cast doubt on the validity of PPP as a long-run relationship between exchange rates and prices, for periods of both fixed and managed floating rates.

The reasons for PPP's failure to hold have been attributed by some economists to "real", as opposed to monetary, disturbances. Examples of these disturbances are differential shifts in consumer preferences over time, or technological innovations and productivity changes at different rates in different countries. It may be the case that the decline in the real exchange value of U.S. goods stems from a long-term fall-off in U.S. productivity relative to that of Japan and Germany.

Whatever the reasons for the failure of PPP as a long-run theory of exchange rates, the research results indicate that forecasters should proceed with caution. Differential rates of inflation can still be viewed as a powerful influence on exchange rates; they simply do not explain everything. *W. Dayle Nattress*

Underlying Currency Diversification

Today's well-integrated and highly efficient Eurocurrency markets are greasing the wheels of private-market currency diversification. Both borrowers and lenders of foreign currencies have begun to shift their portfolios into or away from U.S. dollars in the Euromarkets. Broad markets exist in short-term yen, deutschmark, Swiss franc, and dollar instruments, with less deep, but still highly developed, markets operating in sterling, French francs, and Dutch guilders.

Two influences are often cited as important in spurring currency diversification and, hence, the declining share of U.S. dollars in both lender and borrower portfolios: exchange rate instability and interest-rate differentials. Research by the Chase Economics Group indicates, however, that it is exchange-rate instability that is the prime stimulus to currency diversification, and that interest-rate differentials actually neutralize the exchange-rate stimulus to diversification.

Evidence of diversification is best illustrated with data from the Bank for International Settlements (BIS). The BIS collects data on the size of the Eurocurrency market with currency breakdowns available for a portion of the market. The data indicate that within the European reporting area (which excludes such offshore financial centers as the Bahamas, Bahrain, and Singapore), the U.S. dollar's share of Eurobank liabilities and assets has declined from slightly more than 70% in 1974 to about 65% today. Some qualifications do, however, bear mention. First, although much of the dollar's decline was concentrated in 1977 and 1978, there have been periods of increasing U.S. dollar share. Furthermore, the U.S. dollar share in all Eurocurrency markets is still about 75%-80%, since the dollar dominates heavily in several of the areas excluded from the European reporting area.

Nonetheless, there is no disputing that the dollar has lost ground in the diversification process. The fundamental reason for the decline in the dollar's share appears to be the switch away from the low-exchange-rate-risk environment of the 1960s when the dollar was at the center of the world monetary system. With flexible exchange rates and a much higher degree of foreign-exchange risk, diversification was the only prudent course for borrowers as well as lenders to pursue.

Although the volatility of exchange rates is a key factor in predicting currency diversification, research at Chase indicates that the direction of change in exchange rates (e.g., appreciation or depreciation) is of little importance. This is so because of interest-rate differentials. When a currency is expected to depreciate, its interest rate tends to rise. The differential compensates holders of the weakening currency. Thus, only unexpected, random currency changes are likely to stimulate diversification, since there is no interest-rate protection from such uncertainty—only risk reduction via portfolio diversification. Hence, it is the *frequency* of unexpected rate changes that spurs the currency holder to diversify.

Since foreign-exchange risk appears to be the chief influence on currency diversification, both on the asset and liability side, it is premature to associate automatically currency diversification with either currency weakness or strength. Relative predictability and stability are the critical issues. Thus, even with a stronger dollar, the increased risks associated with a U.S. monetary and interest-rate policy that is highly volatile and unpredictable may cause the dollar's share in the world financial market to erode further.

Bluford H. Putnam

Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	IIIQ/79	IVQ/79	IQ/80	IIQ/80	1978	1979	1980
Gross Size (Claims)	1,041.5	1,110.7	1,117.4	1,205.6	893.1	1,110.7	1,300.0
Net Size (Claims)	630.0	665.0	675.0	735.0	535.0	665.0	785.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	258.9	269.3	274.3	279.5	222.3	269.3	320.0
Liabilities to Private Nonbank Foreigners	65.3	65.8	67.7	69.6	57.8	65.8	75.0
Total Claims on Foreigners	316.7	328.9	324.7	344.4	281.8	328.9	390.0
Claims on Foreign Public Borrowers	39.6	41.5	40.9	41.2	34.3	41.5	45.0
Claims on Foreign Private Nonbank Borrowers	113.1	118.1	118.1	129.3	104.1	118.1	135.0

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.

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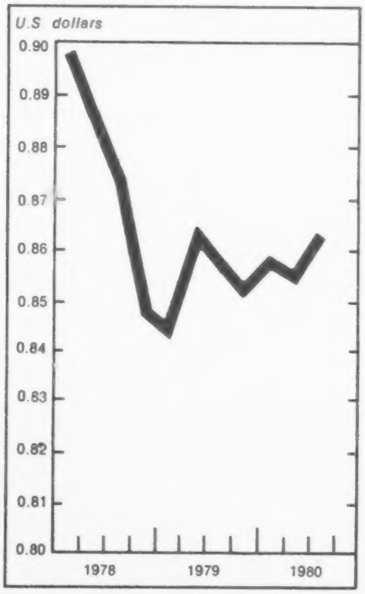
Canadian Dollar Outlook Clouded by Policy Shift

The world financial markets are paying increased attention to the state of debate over economic policy in Canada. There is a growing concern that the long-run implications of present policy drift may have a direct impact on the value of the Canadian dollar. The financial markets are used to political and economic turmoil. Indeed, from the perspective of the Canadian currency, the foreign-exchange markets have absorbed and discounted a series of Canadian political and economic shocks, especially since the 1976 Quebec elections. But they appear to have always focused—after initial adjustment—past the temporary problems and on the fundamental long-run strengths of the Canadian economy. The primary reason for this longer horizon is that market participants have expected that long-run Canadian economic policy would not diverge significantly from policy pursued in the United States. This anticipated convergence of U.S. and Canadian policy has kept the currencies of the two countries reasonably stable against one another, although the relationship has not always benefited the Canadian dollar.

There is a question, however, as to whether these long-run market perceptions may now be changing. As the United States appears poised to move in the direction of a freer economic environment, with deemphasis on the government's role and more stress on private enterprise to solve such problems as energy shortfalls and productivity declines, Canada seems to be moving in the opposite direction. Indeed, as 1981 unfolds Canada may find itself alone among the industrial nations—perceived as fiscally less conservative on various fronts, from fiscal stance to regulation. Much of this perception stems from the debate over energy policy. But there is increasing concern that government attempts to reconcile conflicting political interests will result in a tendency toward expanded public-sector deficits, higher inflation, and ultimately a more accommodating monetary and interest-rate policy.

The unique relationship that exists between the Canadian and U.S. currencies is widely acknowledged and has lent a good deal of predictability to Canadian exchange-rate movements. But it has existed because of the convergence of economic policy in the two countries. Thus, if the long-run economic policies of the two countries are seen as beginning to diverge, the question may be raised of whether the unique currency relationship will remain intact, or reemerge at a new and quite different equilibrium level.

U.S. dollar/Canadian dollar exchange rate
(quarterly averages)



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France's dependence on imported oil played havoc with its 1980 current account.

France's current-account deficit is provisionally estimated at 29.3 billion francs last year, an extreme reversal from the FF4.9-billion surplus of 1979. The deterioration was almost entirely the result of a trade gap that widened from 13.6 billion francs in 1979 to FF60.4 billion last year. And the chief element was the rise in oil prices, which swelled the total energy import bill by 48 billion francs. Oil is at the heart of France's current economic problems, as energy imports (mainly crude oil) satisfy almost 75% of domestic energy requirements. Continued dependence on imported oil makes the economy vulnerable to further price shocks in the short run. This year, the process of adjustment to the recent round of price hikes will again take its toll. The rate of inflation is unlikely to fall below 11%-13%, and a continuation of restrictive monetary policy will bring about a further loss of real economic output. Slowdown in import demand, however, should help offset costly oil imports and trim the trade deficit marginally. Longer-run prospects are more encouraging. France has formulated a highly ambitious energy policy whose objective is to cut reliance on oil from 56% of primary energy needs to 30% by 1990, chiefly by substituting nuclear power.

Danish economy contracting sharply in wake of deflationary policies.

The Danish economy is now showing the results of the deflationary policies adopted last year. Disposable incomes have been cut by 5%, the rate of inflation is running at an annual rate of less than 7%, and the current-account deficit has been kept to some 14 billion kroner. The government's ability to implement unpleasant policies seems to have won international approval, as evidenced by the terms of a $200-million Eurodollar borrowing announced in December 1980. The eight-year loan was granted at ⅜% over LIBOR for the first four years, with the spread rising to ½% thereafter—far better terms than given on previous financings. Nonetheless, economic output in Denmark is falling rapidly, investment has collapsed, and unemployment is edging up toward 8%. The government will thus come under intense pressure this year to relax its restrictive policy stance and stimulate economic growth, even at the expense of worsening inflation and balance-of-payments results.

Swedish kronor under pressure on fears of devaluation.

Gloomy forecasts of Sweden's economic performance presage a devaluation of the kronor some time in the future to improve export competitiveness and reduce the country's balance-of-payments deficit. Official forecasts published on January 12 anticipate a 22.8-billion kronor deficit on current account for 1981 and a swelling of the government's budget deficit to kr.64 billion. These forecasts triggered heavy speculation against the Swedish currency, forcing the authorities to boost interest rates and increase cash reserve requirements for commercial banks. The central bank discount rate was raised from 10% to 12%, with the penalty rate on commercial bank borrowings hiked from 13% to 17%. These responses underscore the government's desire to postpone devaluation until the conclusion of this year's national pay negotiations. The authorities may succeed in defending the kronor this time, but further bouts of speculation in anticipation of an eventual devaluation can be expected later this year.

Reduced oil output dampened Ecuador's economic growth last year.

Ecuador's economic growth rate slowed in 1980 as a consequence of reduced oil output. Real GDP growth is estimated at 4.3% last year, compared with some 5.3% in 1979. Uncertainty about the size of reserves and drilling delays cut average oil production to 200,000 barrels per day in 1980, about 6% below the previous year's average. Other sectors of the economy performed more favorably. Industrial production was up 9%, construction grew 4.2%, and agricultural output expanded by 2.5%. But the strength of the non-oil sectors, combined with rising wages, boosted the rate of price increase to 13% from 10% in 1979. The economic outlook for this year is for some improvement, based on the expectation of stepped-up oil production and continued growth in manufacturing. Inflationary pressures, however, will necessitate caution about excessive demand stimulation.

Paraguay recorded double-digit real GDP growth for the fourth consecutive year.

Paraguay's economy posted 10% real GDP growth last year, sustaining its record of double-digit output gains since 1977. All sectors of the economy contributed to the high growth rate. Agricultural output was buoyed by large increases in soybean, corn, and wheat production, with cotton and meat output showing smaller but still sizable gains. Timber output jumped sharply, and the construction industry recorded a steep rise in output as a result of giant hydroelectric projects under way. The higher level of aggregate demand, however, has kept prices rising at a 22% annual rate. The inflation rate would be even higher were it not for the restrictive monetary and fiscal policies being pursued. On the external front, the trade deficit in 1980 is estimated to have widened slightly. Still, the country's ability to attract international capital was not affected and reserves climbed by about $150 million.

IMF loan to Pakistan opens way for other needed sources of finance.

Late last year, Pakistan reached agreement with the International Monetary Fund on a $1.73-billion, three-year Extended Fund Facility loan, the largest loan ever granted by the IMF to a developing nation. To satisfy the conditions of the loan, Pakistan reportedly agreed to adopt measures to improve the profitability of public-sector enterprises and to slash subsidies further to bring its public-sector deficit under control. Ceilings on domestic credit expansion and on external borrowing by the public sector have also been imposed. Quantitative import restrictions are to be removed, and absolute bans on imports of capital goods, raw materials, and intermediate goods are to be relaxed. As a result of the agreement with the IMF, the Aid-to-Pakistan Consortium is reported to have approved about $270 million in debt relief for the next 18 months at its mid-January meeting. The IMF agreement may also pave the way for a structural adjustment loan from the World Bank.

Economic growth in Ivory Coast is slowing, but oil output prospects are bullish.

The Ivory Coast's coffee and cocoa boom, which gave it an annual average real GDP growth rate of 8% in the second half of the 1970s, has yielded to a period of economic austerity. Economic policy restrictiveness is a response to a substantially worsened balance of payments coinciding with a heavier external debt service burden. But sound economic management and a favorable petroleum production outlook point to a return to faster growth and an improving payments balance by 1982-83. Oil output is currently running about 10,000 barrels per day and satisfies almost one-third of domestic requirements. Production is expected to reach 140,000 bpd in two to three years, leaving an export surplus of some 100,000 bpd. The pace of real GDP growth is projected to drop to 1.5%-2% this year, but is expected to more than double in 1982 as a result of stepped-up petroleum development and a probable easing of public-sector investment restrictions. And the balance of payments, although burdened by increasing debt service payments, should begin improving in 1982 following this year's projected peak current-account deficit of $1.8 billion.

Cotton prices unlikely to rise significantly, despite tight supplies.

The cotton market is unlikely to see significant further price increases this year, despite reduced output and inventories. Estimated production of U.S. cotton for the 1980/81 crop year has fallen to 11.1 million bales from 14 million bales in 1979/80. The output decline occurred despite a 3% increase in harvested acreage, owing to a 26% drop in the average yield per acre—a result of last summer's severe drought. Worldwide production of cotton in the current crop year is down to some 64.1 million bales from more than 66 million bales in 1979/80. And world stocks are expected to decline to 20.4 million bales. Nonetheless, the expectation of weak demand this year and a widening in the price differential between cotton and certain cheaper substitutes should keep cotton prices from rising significantly. The most likely scenario for 1981 is for prices to remain in the 90¢ range, with cotton unable to sustain a price of more than $1 per pound.

NOWs Distort Money Numbers

The unexpectedly rapid growth in NOW accounts resulting from their recent introduction nationwide has created confusion about the significance of weekly money supply statistics. The key unknown is the extent to which the recent jump in the M1-B money supply was the result of this spurt in NOW accounts, and it will take some time before a reliable judgement can be made. In the interim, both the Federal Reserve and money-market participants will have difficulty determining whether money growth is "excessive."

At the start of this year, depository institutions nationwide received authorization to offer negotiable order of withdrawal (NOW) accounts. These accounts are equivalent to interest-bearing checking accounts, with a ceiling rate of 5¼%. NOW accounts are included, along with currency and checking accounts, in M1-B.

In the first two weeks of January, NOW accounts increased by $16 billion, and M1-B rose by $9.7 billion. Estimates of the rise in M1-B attributed solely to the introduction of NOWs vary widely, however, owing to varying assumptions of the sources of the NOW account increase.

If most of this increase represented transfers from checking accounts, the sharp rise in M1-B would have occurred even without the advent of nationwide NOWs. If much of the increase in NOW accounts reflected shifts from savings and time deposits, however, the introduction of NOWs would be a major cause of the M1-B jump. This distinction is important since the Federal Reserve is especially interested in the behavior of M1-B apart from the "nationwide NOW" impact.

Unfortunately, sufficient data are not available to make confident estimates of such effects. A reasonable, although *very* rough, estimate is that about 25%-30% of the rise in NOW accounts represents shifts from time and savings deposits. This estimate—similar to estimates of the effect of the introduction of NOW accounts in New England in the mid-1970s—implies that in the absence of nationwide NOWs, M1-B would have risen by about $5½ billion in the first two weeks of January, instead of the reported $9.7 billion. This is still a large jump, but it implies that M1-B growth may still be below any Federal Reserve growth target.

Of course, the Fed's interpretation of the monetary data may differ from that given above. However, the Fed is well aware that any such interpretation is subject to significant uncertainty. Thus, it will probably place less weight on the behavior of M1-B in coming weeks in formulating policy, focusing more on the broader M2 aggregate. M2 includes small-denomination time and savings deposits and money market mutual fund shares, and is unaffected by the introduction of NOWs. The Fed is also likely to focus more heavily on money-market conditions and less on the monetary aggregates.

The Budget: Thorny Problems Persist

President Reagan will clearly have difficulty reconciling the provision of substantial tax cuts with his budget-balancing goals. The legacy of the Carter administration almost ensures it. In 1976, Jimmy Carter campaigned on a pledge to reduce both the inflation rate and unemployment rate to 4% and to balance the federal budget by the end of his first term in office. But inflation is now running over 12%, unemployment is near 7½%, and revised estimates for the 1981 fiscal year that began October 1, 1980 project a deficit of $55 billion. This shortfall compares with an estimate of $15 billion just one year ago, and is in sharp contrast to the projection of an $8-billion surplus three years ago. For FY1982, the budget submitted by Mr. Carter projects a deficit of $27.5 billion; a surplus is now not projected until 1984.

Even these estimates are likely to prove too optimistic. Any tax cut in the current fiscal year would enlarge the deficit unless offsetting reductions in spending are made. But the fiscal year will be at least half over before Congress could act on any legislative proposals, making offsets more difficult to achieve and a larger deficit more likely.

The herculean problem confronting the Reagan administration, however, is the budget for fiscal 1982. The estimated deficit of $27.5 billion specified in the Carter budget is only a hope. To hold the deficit to this figure, Congress would have to agree to $9.5 billion in spending cuts and to $23.6 billion in revenue increases—chiefly through a 10¢ per gallon excise tax on gasoline and withholding of tax on dividends and income. But Congress refused to approve these two revenue measures in the last session. Moreover, the Carter administration budget only allows for $18 billion in tax reductions, whereas President Reagan's tax cut proposals are likely to exceed $40 billion. Allowing for reflows to the U.S. Treasury of some $10 billion generated by a higher level of economic activity still leaves a gap of nearly $80 billion. Thus, many economists are urging large spending cuts, especially if defense expenditures are to rise.

The above budget estimates are also contingent on Council of Economic Adviser forecasts of real GNP growth of 1¾% in 1981 and 3½% in 1982, with inflation (measured by the GNP deflator) holding at about 10% in 1981 and falling to 9% in 1982. As the Council points out, however, two potential shocks to the economy could invalidate these forecasts. The first is the possibility of another major oil shock that boosts prices sharply. And the second is a possible collision between rapidly rising credit demands and the Federal Reserve's current monetary targets. This would tend to raise interest rates later this year and choke off economic recovery, sending receipts lower and expenditures higher. Given the budget outlook, however, the latter shock appears unlikely to be avoided.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				central bank rate	exchange rate in U.S. dollars		
																January 28, 1981			
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M_1)			current monetary conditions	
Austria	Economy slowing down in wake of German recession; inflation easing from midyear peak of 7.3%.	Apr.	+ 6.6%	67.9	+ 9.5%	Nov.	4,825	+ 33.0%	2.3	0	Slight narrowing of 1980's 42-billion schilling current-account gap seen.	Oct.	+ 6.8%	Oct.	+ 5.4%	6.75%	.0693	Credit continues restrictive.	**Austria**
Belgium	No real economic growth expected this year, after only 1% advance in 1980.	Oct.	— 3.4%	111.0	+ 2.1%	Nov.	8,028	+ 29.3%	1.3	0	Current-account gap expected to widen slightly to over $7 billion this year.	Dec.	+ 7.6%	June	— 1.6%	12.00%	.029965	Renewed franc weakness possible.	**Belgium**
Britain	Economic output still declining, but a turning point is expected before midyear.	Nov.	—11.5%	403.1	+ 0.9%	Nov.	20,891	+ 7.8%	2.1	718	Payments surplus persists, owing to lower imports and growing oil exports.	Dec.	+ 15.5%	Oct.	+ 1.6%	14.00%	2.4100	M_3 growth stays strong, but further rate decline expected.	**Britain**
Denmark	Output falling rapidly in wake of restrictive policy measures implemented last year.	Sept.	+ 9.5%	65.0	+ 3.5%	Nov.	3,274	+ 4.8%	2.1	0	Jan.-Nov. 1980 trade deficit was kr. 13.6 billion, vs. kr. 17.2 billion in 1979.	Sept.	+ 10.6%	Aug.	+ 4.5%	11.00%	.1562	Credit policy tight; competition among banks encouraged.	**Denmark**
Finland	Economy slowing down, but 1981 growth rate will still be among highest in Europe.	Sept.	+ 9.3%	40.5	+ 6.7%	Nov.	1,908	+ 32.6%	1.4	85	Current-account deficit widening sharply.	Oct.	+ 13.3%	Aug.	+ 4.1%	9.25%	.2541	Monetary policy remains restrictive.	**Finland**
France	Industrial production likely to show further drop in first quarter.	Nov.	— 4.5%	475.2	+ 3.2%	Nov.	28,580	+ 71.5%	2.6	0	Reduced import demand may narrow 1981 current-account deficit.	Dec.	+ 13.6%	Oct.	+ 8.3%	9.50%	.2086	Short-term rates ease with franc firm in EMS.	**France**
Germany	Real economic growth estimated at 1.8% in 1980; decline in real GDP likely this year.	Nov.	— 2.4%	766.8	+ 4.5%	Nov.	45,798	— 7.1%	2.9	0	Only small improvement foreseen for current account this year, owing to oil.	Dec.	+ 5.5%	Nov.	+ 6.0%	7.50%	.4812	Rates stay high, owing to weak DM and high U.S. rates.	**Germany**
Greece	Economy appears to have stagnated in 1980; reflationary budget should spur recovery in late 1981.	July	+ 2.0%	38.2	+ 3.8%	Sept.	872	— 9.6%	1.1	103	EEC-related capital inflows could help finance large trade gap.	Oct.	+ 24.3%	Apr.	+19.5%	20.50%	.0220	Credit highly restrictive.	**Greece**
Ireland	Deepening recession prompts government to announce plans to boost public investment.	Aug.	— 2.8%	14.7	+ 1.9%	Nov.	2,426	+ 16.0%	2.7	0	Current-account deficit running at an annual rate of 3-4 billion Irish pounds.	Aug.	+ 18.8%	Nov.	+16.3%	12.75%	1.800	Large budget deficit keeps rates high, despite recession.	**Ireland**
Italy	Economic downturn eases, but leading indicators continue to point downward.	Oct.	— 2.9%	324.2	+ 5.0%	Nov.	22,900	+ 25.1%	2.8	0	Jan.-Nov. trade deficit was $18.5 billion, versus $5.6-billion gap for all 1979.	Dec.	+ 21.1%	Sept.	+15.9%	16.50%	.001013	Credit remains tight.	**Italy**
Netherlands	Sharp recession began last spring; real GNP could contract in 1981.	Oct.	— 0.9%	148.8	+ 2.3%	Nov.	11,382	+ 51.6%	1.8	0	Gas export prices renegotiated in view of rising oil price.	Dec.	+ 6.7%	Sept.	+ 3.8%	8.00%	.4430	Credit easing in wake of guilder strength in EMS.	**Netherlands**
Norway	European recession pinching, but higher oil output ensures a healthy real GDP gain this year.	Oct.	+ 4.2%	44.5	+ 3.2%	Nov.	5,468	+ 25.2%	3.9	0	Payments surplus will narrow in 1981, owing to recent kroner appreciation.	Nov.	+ 13.1%	Sept.	+ 6.8%	9.00%	.1855	Accelerating inflation forces continued tight money policy.	**Norway**
Portugal	Political events have apparently not undermined business confidence.	May	+ 5.3%	19.3	+ 3.2%*	Oct.	1,092	— 3.1%	1.5	114	Current-account deficit forecast to expand slightly to $1 billion in 1981.	Sept.	+ 12.7%	July	+26.1%	18.00%	.0182	Money supply still growing rapidly.	**Portugal**
Spain	The only stimulus in 1981 expected to be public investment; 1% real GDP growth is forecast.	June '79	— 3.1%	196.0	+ 1.5%	Oct.	12,312	— 6.5%	4.5	262	Oil price hike likely to lead to 1981 current-account gap of about $5 billion.	Sept.	+ 14.6%	Sept.	+11.9%	8.00%	.0123	Money supply under control; credit generally available.	**Spain**
Sweden	Economic activity continues to slow down.	Sept.	0	100.6	+ 3.8%	Nov.	3,480	— 0.3%	1.2	0	Trade gap in 1980 was kr. 10.7 billion, versus kr. 4.8 billion in 1979.	Nov.	+ 14.6%	Dec. '79	+16.3%	12.00%	.2199	Credit tightens substantially in defense of kronor.	**Sweden**
Switzerland	Inventory liquidation likely as new orders fall.	Sept.	+ 4.0%	99.0	+ 0.7%	Nov.	12,735	— 8.8%	4.2	—	Trade deficit a record SF 11.2 billion in 1980.	Dec.	+ 4.4%	Oct.	— 7.3%	3.00%	.5330	Credit tight to maintain franc stability against DM.	**Switzerland**
Canada	Increasing demand pressures boosting consumer prices; unemployment rate falls slightly.	Nov.	— 1.7%	222.3	+ 2.7%	Nov.	2,528	— 14.5%	0.5	0	Record trade surplus the result of higher export prices.	Dec.	+ 11.2%	Dec.	+ 8.5%	17.00%	.8345	Bank loans up at 16% annual rate.	**Canada**
United States	Spillover from buoyant growth in late 1980 precludes immediate economic decline.	Dec.	— 1.2%	2,413.9	+ 3.2%	Nov.	14,511	+ 77.6%	0.7	0	This year shaping up as a banner year for U.S. trade.	Dec.	+ 12.4%	Dec.	+ 4.1%	13.00%	—	High interest rates keep dollar strong.	**United States**

*1978

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World Interest Rates

market rates as of Jan. 28, 1981; bond yields as of Jan. 23, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty-large banks 16.00	17.00	14.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.00	7.25
Day-to-Day Money	17.00 Jan. 29	18.00	15.00*	8.60	10.75	9.10	17.50	8.875	2.50	9.0625
Treasury Bills 91-day, Middle Rates	15.05	16.85	12.875*	12.25	n. a.	n. a.	15.60	no dealing	no market	5.875 2-month
Commercial Paper prime, 3-month, asked	16.75 finance paper	17.00 finance paper 15% tax w/h	12.72*	11.50 Certified	11.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.30	17.15 15% tax w/h	13.125*	11.80 Certified	not traded	9.90	20.25	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	12.21	13.00	13.64	10.66 20% tax w/h	13.82	9.09	16.23	10.58	4.80	8.671
Industrial Bonds prime, long-term, new and old issues, average yield	13.10 Aa Industrials	13.875	14.22	14.675	14.71	9.19	16.55	11.58	5.832	7.18
Bank Short-Term Rate to Best Borrowers (prime rate)	20.00	18.25	15.00*	15.75	13.85	11.50	21.00 ⅛ quar'ly fee on outstdng.	11.00	6.00	7.50
Bank Time Deposits 3-month	16.75 Cert. of Dep.	16.25	14.00*	12.05	11.50	9.25	10.75	9.50 large deposits	6.00 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	18.1875	no market	14.25	no market	11.00	9.4375	no market	9.50	6.25	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8345	2.4100	.029965	.2086	.4812	.001013	.4430	.5330	.004883
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.875 *P*	4.50 *P*	6.00 *P*	6.50 *P*	9.375 *P*	1.25 *D*	8.25 *P*	11.50 *P*	8.75 *P*

Eurodollar Deposits
(London, interbank, bid)

Jan. 29	
7-day	17.75
1-month	17.875
3-month	17.8125
6-month	16.875

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	n.a.
U.S.-Canada Treasury Bills	−1.80
U.S.-Canada Finance Co. Paper	− .885
Eurodollars-U.K. Local Auth. Deposits	n.a.

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.50
Over 7 yrs.	14.00
DM Bonds	
7 yrs. and under	9.25
Over 7 yrs.	9.375

Gold Price
London
afternoon fixing

523.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of Jan. 21.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	12.4 (Dec.)	11.2 (Dec.)	15.5 (Dec.)	13.6 (Dec.)	5.5 (Dec.)	21.1 (Dec.)	4.4 (Dec.)	6.6 (Dec.)
Industrial production*	−1.2 (Dec.)	−1.7 (Nov.)	−11.5 (Nov.)	−4.5 (Nov.)	−2.4 (Nov.)	−2.9 (Oct.)	4.0 (Sept.)	1.9 (Nov.)
Trade balance† *(billions of local currency units)*	−$2.98 (Dec.)	C$1.56 (Nov.)	£0.25 (Dec.)	−FF3.57 (Dec.)	DM0.38 (Nov.)	−Lit.1,490 (Nov.)	−SF0.88 (Dec.)	¥500 (Dec.)
Money supply (M_1)*	4.1 (Dec.)	8.5 (Dec.)	1.6 (Oct.)	8.3 (Oct.)	6.0 (Nov.)	15.9 (Sept.)	−7.3 (Oct.)	−1.6 (Nov.)
Velocity of money (M_1)*	4.6 (Dec.)	10.7 (June)	8.6 (June)	n. a.	5.8 (June)	6.2 (Sept.)	n. a.	5.7 (June)
Reserves minus gold *($ million, change from previous month)*	1,710 (Nov.)	−199 (Nov.)	−597 (Nov.)	36 (Nov.)	−827 (Nov.)	791 (Nov.)	893 (Nov.)	253 (Nov.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Adjusting to a Multi-Reserve System

Despite the U.S. dollar's tarnished preeminence in the international monetary system, it remains the world's major reserve currency, accounting for some 80% of the world's foreign-exchange reserves. Reserve diversification has apparently begun, however, with the dollar gradually ceding some of its reserve and portfolio functions to such currencies as the German mark, the Japanese yen, and the Swiss franc. The process was precipitated by instability in the dollar's exchange rate and has been sustained by the expectation of continued dollar volatility.

The forces that have led to the phenomenon of dollar volatility are several. They include declines in U.S. economic growth and productivity coinciding with ballooning fiscal deficits, monetary expansion, and accelerating inflation, in addition to balance-of-payments deterioration and the build-up of dollars abroad. The U.S. government's freezing of Iranian assets last year heightened concerns further, hastening diversification by certain Mideast OPEC members. Having been launched, the process of reserve-currency diversification is expected to continue, reinforced by such factors as changing patterns of international trade and debt and non-dollar currency pegging practices.

Diversification away from the dollar has occurred in the wake of the abandonment of a dollar-centered system of fixed exchange rates in 1973. Had a system of freely fluctuating exchange rates emerged, the need for a reserve currency would have been largely precluded. What has emerged, however, is a system of *managed* floating exchange rates. National authorities have been unwilling to allow their currencies to float freely for fear of being exposed to excessive—and not necessarily corrective—exchange-rate fluctuations. They have instead opted to intervene in the foreign-exchange markets by either buying or selling reserve currencies to support predetermined exchange rate targets for their currencies. This has sustained the need for a reserve-based monetary system, in which several currencies are assuming the role that the dollar once played—under an exchange rate regime that is neither fixed nor floating.

The world's central bankers have moved slowly to diversify their reserve assets--recognizing the dollar's dominant reserve and intervention function and owing to their huge dollar holdings. (The reserve-currency countries actually increased slightly the proportion of dollars in their total reserves between 1970 and 1978, from 91.3% to 93.3%.) Private entities less concerned about the impact of their actions on the dollar exchange rate, however, appear to have moved more aggressively. And the Eurocurrency market has served as the main vehicle for purchasing such non-dollar reserves free from national restriction.

The monetary authorities of the emerging reserve centers remain wary of intervention roles for their currencies, largely because of the perceived constraints on domestic monetary control associated with sudden changes in the volume of externally-held short-term claims. But they have accepted the inevitability of reserve responsibility and are slowly opening up their financial markets to facilitate the requisite capital flows. Large current-account deficits in Germany and Japan have given the monetary authorities in these countries a strong incentive to encourage capital inflows, as has the desire to exercise control over the acquisition of their currencies that has proceeded unchecked in the Euromarkets.

The fundamental international monetary restructuring occasioned by a move from a dollar-based to a multi-currency reserve system has important consequences for international monetary stability. The stresses created by the process—and the measures needed to respond to them—occupied a primary role at a November conference on international monetary stability sponsored by the Philadelphia-based Global Interdependence Center in collaboration with the "Group of Thirty".

The key concern cited at the conference was the potential for heightened exchange-market instability created by the shift to a multi-currency reserve system. The increase in exchange-rate fluctuations, according to the conferees, would stem from the desires of central bankers to alter their currency portfolio mixes at the margin in times of dollar volatility, which could precipitate even larger private portfolio shifts. In general, however, the industrialized-nation central bankers limit their diversification actions to periods of relative dollar stability. They continue to "lean against the wind" by moderating exchange-rate movements and smoothing out speculative excesses through intervention in periods of dollar volatility. But central bankers in many developing nations are beginning to emulate the exchange-rate-management strategies of private currency holders, that is, minimizing risk and maximizing yield.

Various short-term mechanisms have been utilized to accommodate the stresses created by the shift to a multi-currency reserve system. The Japanese and German central banks, for example, have issued non-marketable yen- and DM-denominated government bonds (with maturities of one to five years) to the Saudi Arabian Monetary Agency to minimize potential exchange-market disruption.

For the longer term, however, there are only a limited number of options—or proposals—for restoring

Adjusting to a Multi-Reserve System *(continued from page 7)*

stability to the international foreign-exchange markets. These include: (1) a resurgence of the dollar's role as the world's unchallenged reserve; (2) the adoption of a "Substitution Account" within the International Monetary Fund; (3) a renewed reserve role for gold; or (4) accommodation to the current system of multi-currency reserves.

The dollar could regain its role as the world's unchallenged reserve vehicle if the U.S. monetary authorities succeed in restoring confidence in the dollar with policies that foster stable and non-inflationary monetary growth. If the dollar's exchange value is strengthened—with expectations of dollar stability reinforced—it could recover its past preeminence. Such a development, however, appears improbable, in light of the long history of use by U.S. economic policymakers of a "stop-go" approach, with spurts of monetary and fiscal restraint alternating with expansionism.

Perhaps the most publicized proposal advanced by international monetary reformers to deal more permanently with the problem, however, is the establishment of a Substitution Account within the IMF. Participating central banks would deposit foreign exchange —initially dollars—in an account administered by the IMF, receiving claims denominated in Special Drawing Rights (SDRs). The dollars deposited would be invested in some form of U.S. government obligation and the Account would pay a market-related rate of interest on the SDR claims.

The Substitution Account, however, failed to win approval by an IMF Interim Committee last April for two reasons: the SDR's illiquidity in world financial markets and the disagreement over who would guarantee the Account sufficient funds to pay the interest due on SDR claims in the event that the dollar depreciated relative to the SDR. And despite the SDR's recent redefinition—in which its currency basket was reduced from 16 to 5 currencies, all with forward exchange markets—it is unlikely to assume a key reserve function. The private market resists the concept of a rigid currency basket, which cannot meet the varied requirements of private entities. And if the SDR is not held and traded privately on a large scale, central banks cannot use it as an intervention medium. Moreover, a major reserve role for the SDR would require that the IMF be transformed into a supranational monetary regulator, which is unlikely, particularly in view of prevailing pressures to erode whatever regulatory powers the IMF has now. But although the SDR will probably not assume an important reserve function, its role as a convenient unit of account for both official and private transactions should continue to grow.

As for gold, there is little chance that it will assume a significantly greater reserve role in the future. Having become a speculative commodity, its volatility argues against remonetization. Furthermore, a larger reserve role for gold would necessitate an undesirable dependence on the world's two largest producers: the USSR and South Africa. And modern governments are unwilling to accept the constraints on domestic monetary policy required by a full gold standard.

In sum, the scenario most likely to evolve will be one of continued development of a multiple-currency-reserve system, in which diversification away from the dollar proceeds in fits and starts and where alternative currencies assume varying degrees of reserve functioning at various times. The dollar can be expected, however, to retain its dominant reserve role for some time in view of the currently large dollar capital market, the reluctance on the part of alternative reserve centers to assume important roles, and the incentive offered by U.S. political stability.

The question arises of how the stresses and imbalances associated with an evolving multiple-reserve system can be neutralized. An interim response considered at the Philadelphia gathering was for central bankers to agree on specific guidelines as to the structure of their reserve portfolios, thereby fostering increased exchange-rate predictability. They might also consent to acquire no further holdings in Eurocurrencies in return for some access to the money and capital markets of the new reserve centers. Although the incentives for diversification by the private sector would continue to be economic fundamentals, such inter-central bank cooperation might also moderate pressures for shifts in currency preferences by private currency holders.

The ultimate ingredient for stability in a multi-reserve system, however, is coordination by the major reserve-currency countries of their monetary policies to minimize the underlying incentives for speculative currency shifts. Such a goal is understandably difficult, however, because various national monetary authorities resist subordinating their national interests to those of international monetary cooperation. Nonetheless, should the stability of the world's monetary system continue to deteriorate, such cooperation may be forced onto the world's major central bankers, at a painful cost. Recently, there have been encouraging signs of international economic cooperation, as evidenced by the prevalence of restrictive monetary policies throughout much of the industrialized world. The hope is that such synchronization will be sustained and formalized into deliberate cooperation. The creation of the European Monetary System serves as an interesting—if yet untested—study of explicit monetary cooperation that may be adapted on a global scale.

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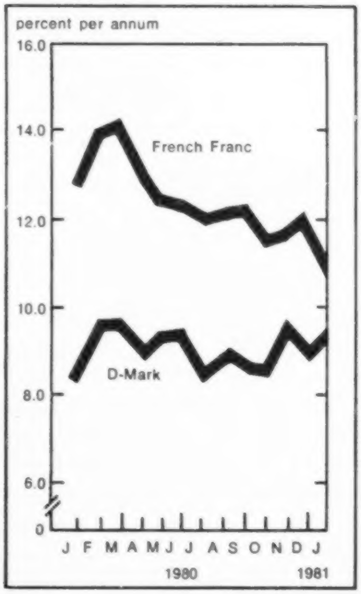
German Monetary Policy at a Crossroads

When the European joint currency arrangement known as the "snake" was enlarged to include France and Italy, most observers expected that the major problem of the new European Monetary System (EMS) would be the strength of the German mark. Since Germany was the member with the lowest inflation rate, it was thought the mark would rise to the top of the EMS currency band and force the other member countries either to adopt tough monetary and interest-rate policies or to devalue their currencies.

The opposite has happened. The German mark has spent most of the last year in the bottom half of the EMS—often the weakest member currency. Germany's low inflation rate was also associated with the lowest interest rates in Europe. And the foreign-exchange markets, when faced with virtually fixed exchange rates, chose the obviously more profitable course of shifting some funds from marks into French francs, guilders, lire, etc., where interest rates were much higher.

Eurocurrency deposit rates
(3-month, asked, end-of-month)



One of the most important lessons of the Bretton Woods system was that individual nations agreeing to fix their currencies to another lose a large measure of control over domestic monetary policy. This is the position that Germany now finds itself in, as its policymakers are being asked to accept the "average" monetary policy of all EMS members. But if Germany acquiesces to the policies of its high-inflation partners, it is placed on a path of slowly-but-surely rising inflation. To the foreign-exchange markets, this means rising interest rates in Germany and capital losses on bonds—a clear reason to move capital into other EMS currencies.

With the United States now on a relatively tight policy course, the strength of the dollar comes into sharp contrast with the "looser" policies of the EMS. Thus, the mark, as well as all EMS currencies, has depreciated sharply against the dollar. And the mark has been extremely weak against its EMS partners.

To arrest the current weakness of the DM, the Bundesbank would have to adopt a more stringent interest-rate policy. But this might threaten EMS stability and would also weaken an economy already in a recession. Thus, the Bundesbank finds itself between a rock and hard place. This does not, however, preclude the need for a decisive policy stance; if nothing is done, Germany could see a 10% inflation rate in a few years. Or it could take harsh steps now, forcing the EMS into a tighter policy stance.

U.K. growth to continue weak, in interest of fighting inflation.

The U.K. economy is now in deep recession, with latest data showing industrial output down 11.5% from a year ago and unemployment at a record 9.3%. This has led to considerable pressure on the government for an expansionary 1981 budget, the details of which are due to be announced March 10. Mrs. Thatcher, however, has reiterated her intention of maintaining current policies until inflation is under control. (Retail prices are still 15% higher than a year ago and the M-3 money supply is up almost 20%.) Most observers are expecting a broadly neutral budget that provides little or no stimulus to growth. Thus, 1981 is likely to witness a continuation of depressed economic conditions, with U.K. output falling further at least until midyear. Some solace can be gained from the gradual deceleration of inflation and monetary growth expected this year and from the reduced interest rates that will probably follow in their path.

Swiss interest rates raised to bolster the franc.

The Swiss monetary authorities demonstrated their resolve to support the franc in the fight against inflation by raising the central bank discount rate from 3.0% to 3.5% on February 3. At the same time, the Lombard rate was increased from 4.0% to 4.5%. Recent franc weakness has contributed to the pickup in inflation. The index of wholesale prices climbed at an annual rate of 8.2% in the fourth quarter of 1980, and higher mortgage rates and labor costs promise a further boost to prices. Swiss interest rates are expected to remain firm as long as the U.S. dollar continues to gain support from high U.S. interest rates, but the franc is expected to benefit most from any downward move in U.S. rates that might occur this year. The Swiss central bank will act to prevent any significant appreciation of the franc against the German mark. This implies scope for an eventual fall in Swiss interest rates that will outstrip any decline in German rates.

Irish economy buffetted by severe recession and high inflation.

An annualized current-account deficit of $1.4 billion and currency weakness have contributed to the severe recession and high inflation now gripping the Irish economy. Against this background, the government announced the details of its new budget on January 28. Official sources describe the budget as deflationary, but its impact is likely to be broadly neutral if not slightly expansionary. Income taxes have been reduced, but sales taxes have been raised, which will boost retail prices and heighten inflationary pressure. The government has announced its intention of reducing the budget deficit from 14.5% of GDP last year to about 13% this year, but most observers fear the deficit could reach 16% of GDP, thereby fueling inflation and widening the balance-of-payments gap. It appears as though Ireland will have to put up with severe recession coupled with a projected average inflation rate of 16% in 1981 (down slightly from 18.2% in 1980), at least until economic growth among its trading partners revives and eases the balance-of-payments constraint.

Tunisia's external-account position deteriorated last year.

Tunisia's overall balance of payments rebounded strongly in 1979, but the improvement appears to have reversed itself in 1980. The current-account deficit narrowed to $300 million in 1979. Merchandise imports advanced 38%, but merchandise exports—mostly of oil—soared 69% and services and transfers receipts jumped 47%. The current-account shortfall was more than covered by long-term capital inflows, and Tunisia recorded an overall payments-balance surplus of $141 million, with a comparable increase in foreign-exchange reserves. External-account data for 1980 have not been published yet, but a rise in reserves of only $11 million to $590 million suggests that the payments surplus narrowed last year. The main reason is a trade deficit for the first three quarters of the year that totaled $970 million—21% higher than the year-earlier period. The deterioration reflected continued fast growth in imports of food, development goods, and oil products coupled with slower growth of merchandise exports. Despite stronger phosphate exports in 1980, certain farm exports fell. And oil export revenues expanded more slowly as output declined by 5% from 1979 while domestic consumption of oil products continued climbing.

Brazil aims to curb economic growth to ease inflationary pressure.

The Brazilian economy registered a real economic growth rate of 8.5% last year, which permitted maintenance of high levels of employment and social and economic welfare. The increased current expenditures that sustained the rapid pace of growth in 1980, however, collided with economic capacity utilization that neared its limits in several sectors, resulting in an acceleration in the rate of inflation to a record 110%. In an effort to reconcile growth and employment objectives with inflation-control, the authorities intend to slow the rate of real economic growth to about 5% this year. A strategy that permits faster growth in sectors with excess capacity, as in agriculture and exports, and lower growth in sectors with high capacity utilization will be pursued. The government hopes that this will permit a gradual decline in the rate of inflation—although no specific targets have been set.

Domestic energy prices boosted in Thailand.

The Thai government, under strong urging by the World Bank, raised domestic energy prices last month. Price rises implemented by the previous administration in February 1980 ultimately led to its downfall, and one of the first official acts of the present government was to roll back some of those increases—especially for kerosene and diesel fuel. The January 1981 price rises—an average of 16%-17%—are still a minimal response to the problem of underpriced energy. Although the price of diesel fuel is now back up to the level proposed by the previous administration, kerosene prices are still below where they were last year. The new schedule boosts average domestic prices some 52% above where they stood in July 1979. But they are still lagging, as average crude prices have risen well over 100% in the same period. The latest price initiative has apparently not precipitated much political opposition, so that further action on the energy pricing front is likely before yearend.

Expenditure cuts needed to avoid repeat of huge budget gap in Sri Lanka.

The government of Sri Lanka last year recorded an overall budget deficit of 15 billion rupees (about $908 million), 22.7% of GDP. This figure exceeded by more than 68% the deficit originally projected. Supplementary expenditures stemmed from financing large food stocks and, on the capital budget, from cost escalations and from official departments exceeding their budgeted ceilings. The increase in the deficit was financed by additional bank borrowing, and the resultant surge in domestic credit triggered an acceleration of inflation, depreciation of the exchange rate, and an outflow of international reserves. To bring the budget under control, the authorities have cut 25% from the 1981 pre-budget estimates of capital expenditure. No supplementary expenditures are to be allowed, and the overall deficit of 11.8 billion rupees is to be financed externally and through non-inflationary domestic borrowing. Costs are still being underestimated, however, and new projects proposed. Thus, unless the government makes offsetting cuts, expenditures in excess of the amount budgeted will occur once again.

Aluminum prices look set to decline sharply this year.

Aluminum prices are likely to fall over the course of 1981, largely because of a buildup in inventories in 1980 and further accumulation anticipated for this year. Although 1981 aluminum production is expected to decline to 12,386,000 metric tons—down 2% from last year after 5% growth in 1980—demand will remain sluggish. The projected weakness in consumption is based on the expectation of flat economic growth in the United States, Europe, and Japan for much of 1981. Indeed, non-socialist world primary demand is expected to grow by less than 1% after having declined by approximately 5% last year. As a result, inventories are estimated to rise to 2,273,000 metric tons this year—equivalent to 2.26 months of consumption, compared with 1.44 months' supply in 1979. The large overhang is likely to put substantial downward pressure on prices, which are expected to experience double-digit declines this year.

The Debate Over Unemployment Benefits

President Reagan's national economic agenda, according to advance billing, will be a program designed to "restore productivity growth, cut inflation, and put Americans back to work." The precise strategy the president plans to propose for putting as many as possible of the 7.8 million unemployed back on the job is not yet clear. The specifics of his policy prescription will not be revealed until later in the week. But several elements of the government's program of alleviating unemployment—such as the Trade Assistance Act—are reported to be prime targets on the Reagan list of items that may be singled out for spending cuts. These cuts, if proposed, would undoubtedly be highly controversial. Yet there is some evidence to suggest they could lead to lower unemployment by increasing the incentive of unemployed workers to find jobs.

Recent economic and employment data, along with the gloomy outlook for 1981, suggest that the official unemployment rate will probably remain high, ensuring tough resistance to any Reagan initiatives. Despite the surprisingly vigorous economy in the second half of 1980, the unemployment rate during the past nine months has fluctuated within a narrow range of 7.4%-7.8% of the civilian labor force, settling at 7.4% in both December and January. Given the prospect of a sluggish economy or even a renewed downturn in 1981, there is little hope that the unemployment rate will move substantially lower any time soon.

Forecasters have mixed views over the future direction of unemployment. If it remains close to current levels, such cyclical behavior would conform to the pattern set by previous business cycles, with the trough in the unemployment rate being higher in successive cycles. On the other hand, other employment statistics indicate that a gradual strengthening has been taking place in the labor markets since July. Employment as measured by the survey of employer payrolls has now risen six straight months in a row; in January it stood at 91.5 million workers. The average factory workweek has also registered six consecutive monthly advances; at 40.4 hours it is now at is highest level since March of 1979. And overtime in the manufacturing sector is now back to pre-recession levels. The layoff rate also has shown consistent improvement since June, although it is still well above year-ago levels. The continued high unemployment rate in the face of these improvements raises the question of whether it is wise to cut unemployment benefits at this time.

There are many positive things that can be said for providing workers with some financial insulation from the hardships of unemployment—with the returns accruing not only to workers and their families, but also to society as a whole. Unemployment benefits are designed to help minimize economic and emotional dislocation for workers out of a job. It can be argued that the entire economy benefits from a system of unemployment insurance, in that unemployed workers feel less pressure to accept jobs that are below their level of skills. Thus, the argument goes, better use is made of the nation's stock of human capital.

There is concern, however, that not enough attention has been given to the costs associated with the present system of unemployment benefits. The extensive public and private system of compensation for the unemployed has long been identified as a rigidity that inhibits both job search and risk-taking. Further, opponents contend, the programs have now gone far beyond their originally intended purpose of providing worker security against cyclical fluctuations in the economy. They have become an extreme drag on labor market mobility and on the national budget as well. Federal outlays for unemployment compensation in fiscal 1980 totaled $19.5 billion, and a 44% increase in that figure is expected in fiscal 1981.

Unemployed workers today may be eligible for up to 39 weeks of unemployment compensation from the government. Additional benefits are available if it is determined that their job loss was due to foreign competition. Moreover, some firms or unions provide supplemental unemployment benefits. This situation contrasts with that of 1948, when the maximum duration of government benefits was 16-20 weeks, at much lower payment levels.

Empirical research indicates that both a higher level and longer availability of benefits tend to increase the duration of unemployment, probably because they lower the costs to unemployed workers of extending their job-search time. Thus, part of the explanation of why the unemployment rate has hovered near 7.5% for so long in the current business cycle probably lies in the nation's system of unemployment compensation. With such a generous level of benefits, many workers may have postponed looking for another job long after it became obvious that their job loss was permanent rather than temporary. Others may have turned down offers of jobs that were not everything they might have hoped for. And still others may have remained in the labor force—and counted as unemployed—only to continue their eligibility to receive unemployment compensation.

With the Reagan administration now in office, it is likely that the mood in Washington toward providing workers with liberal unemployment insurance benefits has changed. There is already talk of plans to propose a tightening of unemployment compensation eligibility requirements. And the current program of providing 13 weeks of extended benefits when unemployment rises above a specified target level may not survive the budget axe. President Reagan himself has stressed that the emphasis now in policymaking will be toward "rewarding hard work and risk taking" by forcing the government to live within its means.

Diana Bailey

Asia and Oceania

Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
													12-month changes				exchange rate in U.S. dollars	change from year earlier		
			6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	February	10, 1981	current monetary conditions	
Asia	**Bangladesh**	Foodgrain output in fiscal 1981 expected to be a record 13.8 million tons.	Aug.	+ 5%	13.7	$ 160	Dec.	300	— 22%	1.4	269	IMF Extended Fund Facility of 800 million SDRs approved for 1981-83.	Oct.	+10%	Aug.	+15%	.0650	— 1%	Tighter monetary policy likely.	**Bangladesh**
	China, People's Republic	Rapid growth in light industry and textiles kept 1980 industrial growth above 8%.	Dec.	+ 20%	517.0	510	June	3,305	— 7%	2.1	277	Coal exports to expand while petroleum development continues.	n.a.	—	—	—	.6250	—11%	Central control over foreign exchange and budget increases.	**China, People's Republic**
	Hong Kong	Recession in manufacturing sector expected to last through first half of this year.	Oct.	+ 28%	17.6	3,320	n.a.	—	—	—	—	Trade deficit in 1980 estimated at $2.5 billion.	Oct.	+14%	Oct.	+30%	.1890	— 8%	Loan demand buoyed by property and equity boom.	**Hong Kong**
	India	Oil price increase passed on in its entirety to consumers.	Sept.	— 19%	126.3	194	Sept.	7,629	0	6.6	339	Costlier oil imports could push trade deficit to near $6 billion.	Sept	+11%	June	+ 4%	.1230	— 2%	Foreign borrowing rises to finance current-account gap.	**India**
	Indonesia	Planning and financial arrangements for large capital projects dominate business news.	May	+ 61%	46.9	316	Dec.	5,392	+ 33%	7.3	0	Despite rising reserves, borrowing in international markets continues.	Dec.	+17%	Aug.	+47%	.001605	+ 1%	Exchange rate with dollar remains stable at 625.	**Indonesia**
	Japan	Outlook bullish for investment, consumption, and industrial output; 5% real GDP growth expected.	Sept.	+ 29%	1,015	8,760	Dec.	24,636	+ 26%	2.1	0	Current-account deficit expected to narrow sharply in first half.	Nov.	+ 8%	Oct.	— 2%	.004908	+20%	Prices to moderate and credit to ease slightly.	**Japan**
	Korea	Signs that recession may end soon include inventory decline and stabilized industrial output.	Oct.	+ 14%	60.2	1,601	Nov.	3,297	+ 12%	1.8	683	Exports rising, with export letter-of-credit arrivals up strongly.	Nov.	+33%	Oct.	+15%	.001525	—11%	Exchange-rate depreciation slows after sharp decline.	**Korea**
	Malaysia	Investment in resource-based industries gathering momentum.	Aug.	+ 20%	19.4	1,458	Oct.	4,666	+ 18%	5.3	0	Exchange rate weakened by higher external interest rates.	Nov.	+10%	Oct.	+14%	.4464	— 3%	Inflationary pressure to continue strong in 1981.	**Malaysia**
	Nepal	Sixth five-year plan emphasizes agriculture and maintains heavy reliance on foreign aid.	Sept.	— 29%	1.7*	128	Dec.	190	+ 16%	6.2	24	Oil-induced trade deficit widens; earnings from tourism falter.	Oct.	+18%	July	+13%	.0870	+ 4%	Inflation rate of 25% spurs credit restrictiveness.	**Nepal**
	Pakistan	Cotton and rice output to decline slightly while wheat and sugarcane production increases.	Oct.	+ 7%	23.0	288	Dec.	496	+133%	1.0	382	Imports of inputs liberalized to spur production and exports.	Oct.	+12%	Oct.	+21%	.1020	+ 1%	Reduced deficit financing will cut credit growth.	**Pakistan**
	Philippines	Business confidence enhanced by end of martial law and new central bank governor.	Aug.	+ 26%	29.8	625	Dec.	2,846	+ 26%	4.0	853	World recession and weak prices for commodities point to export problems.	Oct.	+14%	Sept.	+20%	.1355	+ 1%	Interest rate ceilings may be lifted.	**Philippines**
	Singapore	Slowdown in direct investments by multinationals prompts reassessment of new industrial policy.	Oct.	+ 35%	8.9	3,790	Sept.	6,462	+ 13%	3.1	0	Exchange rate buoyed by speculative capital inflow.	Nov.	+ 7%	Sept.	+16%	.4819	+ 4%	Money supply inflated by rising financial investments.	**Singapore**
	Sri Lanka	Capital expenditures of major ministries cut 25% to reduce budget deficit.	Aug.	+ 4%	3.3	226	Aug.	325	— 28%	2.4	269	High investment shows up in large current-account gap.	Oct.	+23%	Sept.	+15%	.0570	—10%	Credit growth to slow with reduced deficit financing.	**Sri Lanka**
	Taiwan	Real GNP growth in 1980 was about 7%; 1981 performance should be no worse.	Nov.	+ 19%	32.2	1,716	n.a.	—	—	—	—	Despite recession in major export markets, trade account remains in balance.	Nov.	+23%	Oct.	+21%	.0290	0	Bank competition and investor confidence boost loan growth.	**Taiwan**
	Thailand	Real GNP growth in 1980 estimated at 6.5%.	Oct.	+ 16%	27.3	591	Dec.	1,560	— 15%	2.1	182	High oil prices and strong demand for imports widen trade gap.	Oct.	+17%	June	+15%	.0505	+ 3%	Interest rates expected to remain high.	**Thailand**
Oceania	**Australia**	Resource development programs just beginning will contribute to 3%-4% real GDP growth this year.	Dec.	+ 10%	119.1	8,258	Dec.	1,690	+ 19%	0.9	79	Trade surplus expected, despite sluggish export performance.	Sept.	+10%	Nov.	+17%	1.1660	+ 6%	Tight credit policy directed at price stabilization.	**Australia**
	New Zealand	Real GNP growth projected at 1% in 1981, owing to flat industrial output and political uncertainty.	Oct.	+ 15%	20.7	6,591	Nov.	423	— 30%	0.9	169	Increased imports and flat exports widen current-account deficit slightly.	Sept.	+16%	Oct.	+ 1%	.9450	— 4%	Credit conditions restrictive to reduce 15% inflation rate.	**New Zealand**
	Fiji	Recession in Western countries threatens decline in tourist business.	Oct.	+ 29%	1.1	1,797	Dec.	168	+ 24%	1.1	0	Strong sugar earnings boosted exports and reserves last year.	Dec.	+15%	Nov.	— 2%	1.2525	+ 5%	Oil price rises push inflation rate near 20%.	**Fiji**

*1978

World Interest Rates

market rates of Feb. 10, 1981; bond yields as of Feb. 6, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty-large banks 16.00	17.11	14.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.50	7.25
Day-to-Day Money	16.625 Feb. 11	17.50	14.50	9.55	10.8125	9.25	17.50	9.00	4.25	8.6875
Treasury Bills 91-day, Middle Rates	15.46	16.95	13.3125	12.50	12.72 one-year	n. a.	15.549 78-day	no dealing	no market	5.875 2-month
Commercial Paper prime, 3-month, asked	15.50 finance paper	17.50 finance paper 15% tax w/h	12.184	11.50 Certified	15.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	15.80	17.50 15% tax w/h	12.625	11.80 Certified	not traded	9.90	n. a.	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	12.74	13.30	13.62	11.425 20% tax w/h	14.03	9.55	16.41	10.79	4.85	8.27
Industrial Bonds prime, long-term, new and old issues, average yield	13.45 Aa Industrials	14.00	14.20	14.915	14.92	9.75	16.64	11.63	5.975	7.03
Bank Short-Term Rate to Best Borrowers (prime rate)	19.50	18.25	15.00	15.50	13.85	11.50	21.00 ⅛ quar'ly fee on outstdng.	11.00	6.00	7.50
Bank Time Deposits 3-month	16.25 Cert. of Dep.	16.70	13.3125	12.35	11.6875	9.65	10.75	9.625 large deposits	6.625 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	17.125	no market	13.375	no market	11.00	10.125	no market	9.625	6.6875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8354	2.3420	.02907	.2023	.4668	.000986	.4301	.5141	.004910
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.333 *D*	3.875 *P*	4.125 *P*	6.25 *P*	6.75 *P*	1.00 *D*	7.00 *P*	9.875 *P*	8.125 *P*

Eurodollar Deposits
(London, interbank, bid)

Feb. 11	
7-day	15.125
1-month	17.125
3-month	17.0625
6-month	17.00

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.54
U.S.-Canada Treasury Bills	−0.23
U.S.-Canada Finance Co. Paper	−1.43
Eurodollars-U.K. Local Auth. Deposits	+0.0625

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	13.50
Over 7 yrs.	13.75
DM Bonds	
7 yrs. and under	9.625
Over 7 yrs.	9.875

Gold Price

London
afternoon fixing

519.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Non-Oil-Exporting LDCs: External Sector Developments (1971-80)

(billion dollars, end of period)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Current Account Deficit[1]	11.4	10.8	11.5	36.9	45.9	32.9	28.6	35.8	52.9	68.0
Increase in Official Reserves[1]	1.3	6.4	9.7	2.1	−2.0	12.8	12.0	18.0	11.6	8.8
External Debt Outstanding										
World Bank:	54.2	62.1	75.9	94.8	114.9	139.0	172.0	211.6	246.4	279.5
Augmented:[2]	72.0	81.0	95.0	115.6	154.9	194.4	219.8	273.4	295.8	380.0

[1] IMF

[2] World Bank and B.I.S. data.

Short-Run Adjustment to Deficits by LDCs

The post-1973 period has been marked by major disturbances in the balance of payments of the non-oil-exporting less-developed countries (LDCs). The aggregate current-account deficit of these countries rose from approximately $12 billion in 1973 to about $68 billion in 1980 (see table on bottom of page six). And it is estimated that the combined deficit of the non-oil-exporting LDCs will approach $85 billion by the end of this year. This alarming increase has renewed concerns about economic stagnation and about possible threats to the stability of the international financial system. The manner in which these countries respond to their expanding deficits thus has important implications for the international economy.

Adjustment by the non-oil-exporting LDCs to current-account deficits occurs in both the short and long run. In the short run, such countries have attempted to cut back imports, draw down reserves, or borrow abroad; they have usually utilized a combination of these options. Over a slightly longer period, the non-oil-exporting LDCs have sought to spur exports.

Short-run adjustment to deficits by the non-oil-exporting LDCs has received little attention by international economists, but the issue has become critical to the growing LDC debt problem. Since 1973, the major manifestation of short-term adjustment has been the rapid accumulation of external liabilities by the non-oil-exporting LDCs. External debt totaled an estimated $380 billion at the end of 1980, compared with just $95 billion at the end of 1973. And with the massive OPEC recycling process having been handled within the commercial banking system, an increasing portion of this debt is owed to private lenders.

The developments that have contributed to the recent deterioration in the external accounts of the non-oil-exporting LDCs include huge oil price rises, export stagnation owing to worldwide inflation, and domestic supply disruptions (caused by poor weather, political strife, or port and border closures). Following the initial "recognition lag"—the time it takes to recognize the problem and formulate a short-run adjustment policy--the ultimate course of action by the LDCs is determined by the costs and benefits of each policy.

The import-squeeze option

The degree to which non-oil-exporting LDCs can cut imports to reduce their deficits depends on the "compressibility" of imports, which in turn depends on their composition. In this connection, the proportion of maintenance items (raw materials and intermediate goods) to total imports; the ratio of imports that are competitive with domestic products to those that are not; and the share of (rather squeeze-resistant) government imports in total imports are significant determinants. Interestingly, the ratio of imports to GNP—the degree of trade-dependence—is not necessarily a reliable indicator of the ease or difficulty of import reduction as an adjustment response. A low ratio often implies that all but the most essential imports have already been eliminated, so that any further restriction results in very high costs to the economy. The import-squeeze response is also problematic in that restraints on the import of essential goods, in most countries, have had serious social and political repercussions. Furthermore, the proportion of government revenues that is derived from import taxes is an important element in explaining resistance to import-reduction policies.

Reserve drawdown and foreign borrowing

The drawdown of international reserves is another short-term choice of the deficit-ridden non-oil-exporting LDCs. The rate of increase in their official reserves stepped up dramatically after 1975—nurtured by the easy availability of cheap credit. The reserve accumulation cushioned the impact of the sharp oil price rise of mid-1979, allowing the authorities in the non-oil-exporting LDCs to avoid the use of debilitating import-squeeze policies.

The third short-run response of the non-oil-exporting LDCs to current-account deficits has been external borrowing. And an important determinant of the use of this option is the cost of external finance. Favorable loan terms are not always sufficient to induce foreign borrowing, however, if the external finance is tied to specific procurement. This is because previous debt-servicing requirements preempt large portions of untied external finance, and any subsequent tied finance limits the LDCs' flexibility. In general, high levels of external debt are associated with low levels of future debt—as commercial lenders are more wary of repayment by overborrowed debtors. This, or course, implies greater reliance on import squeezing in periods of low levels of foreign exchange. An interesting phenomenon in this connection is the sometimes perverse impact of high levels of existing debt in an LDC. A heavy debt burden sometimes ensures continued access to credit at favorable terms, especially from commercial lenders seeking to avert default on past loans.

The early 1980s will likely witness modification of the short-term adjustment strategies of the non-oil-exporting LDCs. The upper limits to external financial sources are being reached, while reserve stockpiles are gradually being eroded. This suggests that the non-oil-exporting LDCs will be forced to cut imports—and real economic growth plans—to avoid serious external-account deterioration in the short run.

Deepak Bhattasali

Balanced Growth a Goal for Nigeria

The Nigerian economy has ridden the crest of steep price rises for its chief "crop"—oil—and its balance of payments has improved accordingly. In deficit by some $3.8 billion as recently as 1978, Nigeria's current account shifted into surplus by $1.2 billion in 1979; and that surplus appears to have expanded to $3.0 billion in 1980. Export earnings last year—over 95% of which came from oil—totaled approximately $25½ billion, up 52% from 1979. Import costs are estimated to have risen by 50% to $17.8 billion, owing to an easing of import controls.

The remarkable balance-of-payments improvement is the result of huge price increases for Nigerian oil; price rises averaged 50% in 1979 and 71% last year. Average annual oil output, however, has remained relatively stable. Indeed, oil production last year actually declined slightly—to 2.0 million barrels per day from 2.3 million barrels daily in 1979.

Although overall real GDP growth was about 8% last year, the 1980 economic showing apart from the oil sector was disappointing. Manufacturing output remained stagnant because of a scarcity of raw materials and spare parts. And the agricultural sector, which employs 70% of the population, failed to boost output and continues to fall short of meeting domestic food needs. Food imports in 1980 are estimated to have cost Nigeria over $2 billion, more than 13% of total import costs.

The shortfall in domestic output of food and the heavy imports have also aggravated inflation, estimated at 15% in 1980. Also, the civilian government of President Shagari last April eliminated the wage freeze of the previous military government and replaced it with a system of free collective bargaining, in which guidelines link pay increases to rises in productivity. But the lack of adequate statistical data has made the system unworkable, with the likelihood that wage increases will exceed productivity gains.

The outlook to 1983

The near-term outlook is for annual real GDP growth to continue in the 7%-8% range, with the rate of inflation likely to accelerate, owing to shortages of food, housing, and household goods. And imbalances in the economy will persist. The oil sector—accounting for about 30% of GDP—will continue to dominate, with agricultural and industrial development unlikely to advance significantly.

The government has acknowledged the importance of agricultural development to Nigeria's long-term economic and political future. An important goal of its four-year (1981-85) $151-billion development plan is self-sufficiency in food, but the chances of significant improvement in the near term are poor largely because of agriculture's limited capacity to absorb investment. Similarly, major efforts to promote industry have so far met with only limited success. Structural barriers include insufficient investment in basic industries, inadequate support for existing industries, and a lack of industrial planning coordination. Sustained efforts to spur manufacturing activity should, however, lead to a moderate increase in this sector's current 8.7% share of GDP over the plan period.

Oil to remain paramount

Oil production will thus remain the lynchpin of economic growth in the near term. Output, however, is unlikely to rise much above 2.2 million barrels per day in the next two years, with domestic consumption expected to increase about 12% per year. Thus, whatever higher oil revenues materialize will result from price rises. But with world oil demand likely to be soft because of weakness in the industrialized nations and the probability of rapidly rising imports, Nigeria's large current-account surplus should narrow markedly this year and could swing into deficit as early as 1982.

There are, however, no signs of any foreign-exchange shortage emerging, as Nigeria's international-reserve cushion is well-padded. Reserves (minus gold) totaled $10.1 billion as of end-November 1980, equivalent to 5.5 months of imports. Moreover, Nigeria is considered to be underborrowed in international financial markets. The World Bank places end-1979 external debt at $5.7 billion (with $3.7 disbursed). Debt service payments of $560 million in 1980 represent only 2.1% of foreign-exchange earnings.

In sum, while oil output is critical to economic growth, Nigeria must overcome serious obstacles to the development of viable agricultural and industrial sectors. However, its huge financial and oil reserves (known oil reserves are estimated at 25 billion barrels) and its awareness of the importance of economic diversification afford Nigeria the opportunity to achieve broad-based economic development.

Wally V. Koch

Key External Indicators
(billion dollars, end of period)

	1977	1978	1979	1980 est.	1981	1982 projected	1983
Trade Balance	2.7	0.9	4.9	7.7	6.0	5.0	1.5
Current-Acct. Balance	−1.0	−3.8	1.2	3.0	0.5	−1.0	−3.2
International Reserves	4.2	1.9	5.5	10.1	12.3	13.0	12.0

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Expectations the Key to Success of New U.S. Policies

The Reagan administration's estimates for the U.S. budget deficit in fiscal years 1981 and 1982 may well prove optimistic. Although the government's forecast of a $54.5-billion shortfall this year is likely to be exceeded only slightly, the actual gap in fiscal 1982 could be dramatically wider than the $45 billion currently projected by the new administration.

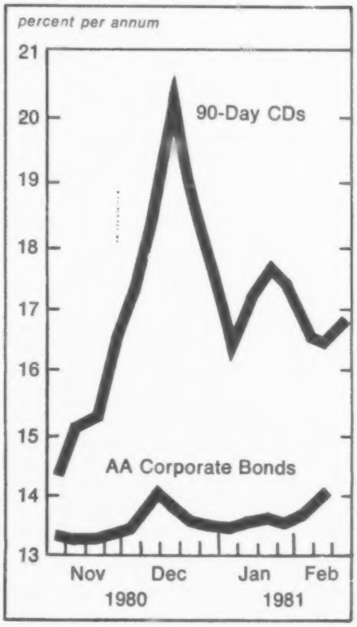
The basic premise behind the government's conservative deficit estimate for fiscal 1982 is its assumption that forceful action will dampen inflation expectations quickly. It is believed that this would then reduce interest rates and permit faster economic growth later this year, with even more rapid gains in 1982. The administration projects real GNP growth of 4.2% next year, with consumer prices rising 8.3%—a rather strong improvement over real economic growth of 1.1% and an inflation rate of 11.1% expected for 1981.

The sharp improvement seen for 1982 hinges on positive returns to the Reagan formula of comprehensive budget cuts, reduced government regulation, and restrictive monetary policy, which are aimed at dampening inflation expectations, accompanied by tax cuts to stimulate real economic growth. But there are several problems with this formulation.

First, there is concern that the tax cuts will be implemented before all the spending cuts are passed, as evidenced by bond market participants pushing AA utility bond rates up 75 basis points since the inauguration, despite a 250-basis-point drop in short-term rates. The recent weak growth in the narrow money supply that has allowed short-term rates to fall may augur a renewed economic downturn in the coming months, which could spur hasty passage of the tax cuts, confirming the bond market's fears. If the Federal Reserve accommodates the fiscal stimulus with rapid monetary expansion, adverse expectations could be fueled further, boosting inflation and dampening real growth this year and next.

But even if all the spending-cut and tax-cut proposals are passed, the surge in growth and lower inflation envisaged by the government are still unlikely to be realized quickly, largely because of the stubbornness of expectations. Past experience suggests that at least several months of sustained easing in actual inflation will be needed to lower inflation expectations. Sustained declines in inflation will not be accomplished easily, however, because of the long build-up of inflationary momentum as well as doubts about Congressional willingness to reverse the long-term trend toward larger government.

Short- and long-term interest rates



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Weak mark takes precedence over recession in recent German credit tightening.

The persistent weakness of the German mark has forced the Bundesbank to tighten credit, despite the domestic recession. The central bank's traditional Lombard facility—under which banks borrow funds from the Bundesbank using securities as collateral—has been temporarily withdrawn, and banks have had to repay outstanding borrowings estimated at 6.5 billion DM. Replacing the former facility is a special Lombard facility whose interest rate will be set daily by the Bundesbank. The new policy gives the monetary authorities much more flexibility in influencing the level of short-term rates, which are not only likely to rise in the near term, but also to show greater daily volatility. If exchange market speculators do not expect the German mark to be devalued against its European Monetary System partners, the recent tightening sets a floor to the DM exchange rate on forward markets. Heightened German interest-rate volatility would then be reflected in greater fluctuations in the spot DM/EMS exchange rates, or, less likely, in greater volatility in the interest rates of EMS partners.

Austrian monetary policy unlikely to loosen, despite recession.

The Austrian economy has not escaped the European recession unscathed. Real GDP is now expected to decline slightly after its estimated 3.5% growth last year. And the domestic slowdown is likely to boost the 1981 net budget deficit to 29 billion schillings from the planned level of 25 billion (although this is still below the estimated shortfall for 1980). Despite the sluggish growth of domestic demand, however, the country's current-account deficit is expected to narrow only slightly from 1980's 47 billion schillings as Austria's export markets, especially Germany, continue to weaken. Thus, the recent credit tightening in Germany would seem to preclude any early relaxation of Austrian monetary policy, which, given Austria's hard-schilling policy, is largely determined by the foreign-exchange market.

Norwegian export competitiveness and inflation under strain.

Norway is faced with a number of short-term economic problems, although its huge oil reserves make its long-term prospects uniquely bright. Some of its current problems are the product of recession among its trading partners, which is dampening exports, and others follow from the economic strains of oil development. One such strain is the rapid increase in wages enjoyed by North Sea oil workers, whose skills are in short supply and whose pay rises have tended to spread to other sectors of the labor market. As a result, the improvement in relative costs that was seen in 1978-79 has now reversed itself, a further depressing force on exports. Wage increases have also contributed to accelerating inflation. The rate of inflation reached a year-over-year rate of 13.7% at the end of 1980, and it is expected to average 13% this year. Further straining Norwegian exports is the kroner exchange rate. The kroner has begun to show signs of petrocurrency status, rising from 2.87 per deutschemark at the start of 1980 to 2.47 per DM in mid-February. All in all, however, the economy is in sound shape. The country is still running a trade surplus—1.38 billion kroner in January after a kr. 5.2-billion surplus for all of 1980. And despite the slackening of economic activity, unemployment is still less than 1.5%.

Iraqi economy running smoothly and cushioned by plentiful reserves.

With the exception of oil exports, the Iraqi economy is reportedly functioning remarkably well, despite the war with Iran. Reports from Baghdad indicate that construction work, in particular, has continued uninterrupted. Oil exports, however, have dropped back from their peak in early December when exports through the two Mediterranean pipelines exceeded one million barrels per day. Since then, the Syrian pipeline has been closed, and exports through Turkey have only averaged some 400,000 barrels daily. Iraq, however, does not face the prospect of a foreign-exchange shortage even if exports halt completely, as conservative estimates place total foreign-exchange reserves in excess of $20 billion. In the interim, Iraq is reported to be discussing contracts with the Japanese for shipment of 200,000-300,000 barrels per day at $37.20 per barrel—which could mean a renewed upturn in exports. For the longer term, the Iraqis are finalizing the details of a 1981-85 plan. Total plan expenditures of more than $75 billion are anticipated, which will keep Iraq the second biggest Middle East market for Western companies.

Venezuela posted negative growth in 1980, but doubled its trade surplus.

Real GDP in Venezuela declined by about 1.6% in 1980, following an expansion of less than 1% in 1979. The contraction last year was primarily the result of an 8% drop in petroleum output, with production returning to a more normal level of 2.17 million barrels per day from the high of 2.36 million bpd averaged in 1979 in the wake of the Iranian shortfall. The country's non-petroleum sectors stagnated or experienced modest declines. And the rate of inflation continued at its previous year's level, averaging about 22% in the fourth quarter of 1980, on a fourth-quarter-over-fourth-quarter basis. The bright spot was the external sector. The 64% jump in average petroleum export prices pushed total export earnings to $20 billion last year from $14.2 billion in 1979. With imports estimated to have risen slightly to $12.5 billion, the trade surplus more than doubled to $7.5 billion.

Australian economic showing threatened by tight money policy at home and abroad.

The restrictive monetary policy pursued by Australian authorities in fiscal 1980/81 (ending March 31) appears to be bearing fruit. Consumer price inflation is currently running at a 9.2% annual rate, compared with 10.8% last year. And it seems that the government will meet its money growth target of 11%. Some serious risks remain, however, and the coming months are particularly important. Short-term interest rates are expected to rise to about 17%, which could undermine the recent bond market revival. Furthermore, the path of U.S. interest rates in the next few months will prove critical to the Australian economy by altering the volume of capital inflows into the country. If the interest-rate differential increasingly favors the United States, it can cause a severe credit squeeze in Australia (by aggravating a period of traditionally tight money conditions) and brake the slowly rising real annual GDP growth rate of 3.5%. Or it can accommodate credit demands, with only minor tightness at the margin.

Indonesian economy booming, paced by oil and gas.

Indonesia's is a boom economy. Real GDP growth was an estimated 9% in 1980, a record. And the momentum is continuing, with oil and gas setting the pace. Aggressive exploration activity in the last few years has lifted the rate of oil output, and rapidly expanding gas production has brought in new foreign exchange and spawned downstream chemical industries. Agriculture and commodities-based manufacturing are also doing well, and the timber processing industry is currently buoyed by a region-wide construction boom. The financial and property sectors are seeing increased business volume and profitability, owing to the strong export earnings and the government's policy of liberal spending on development. All of this activity, however, has fueled inflation. Consumer prices have been rising at a 20% rate and show no sign of moderating this year. But this is viewed as a small price to pay for the welcome prosperity.

Silver price weakness expected to continue.

Market forces are expected to keep silver prices in the $12-$15 range this year. Non-Socialist world demand for refined silver is projected to decline by 2% in 1981, owing to the worldwide recession, particularly in Japan, while production is forecast to increase by about 4%. And speculative demand is unlikely to be an important factor this year because of the high level of interest rates in the United States and abroad. The surplus will lead to a build-up in silver inventories; these are expected to grow some 26%, from 190 million troy ounces at the end of 1980 to about 240 million troy ounces at the end of this year. The quantity supplied is also likely to exceed the amount demanded in 1982, with a further 25% inventory accumulation estimated.

Money Targets Suggest Tightness in 1981

In testimony before Congress last week, Federal Reserve Chairman Volcker announced that the Federal Reserve's 1981 target growth ranges for the narrow money supply measures have been reduced by one-half percentage point from those of 1980. He also stated that the 1981 target growth ranges for the broader money supply measures and for bank credit would not be changed. These announcements were in line with the markets' expectations. And the new targets confirm that recent money growth has been well below target, and that the Federal Reserve plans to maintain a tight monetary stance for 1981 as a whole.

The one-half percentage point reduction in the target growth ranges for the narrow money measures—to 3%-5½% for M1-A (currency plus demand deposits) and to 3½%-6% for M1-B (M1-A plus other checkable deposits) —does not apply to the "raw" money data released by the Fed. Rather, it applies to M1-A and M1-B adjusted for the effect the nationwide introduction of NOW accounts has had and will continue to have on these money measures. NOW accounts are included in M1-B but not in M1-A, and the Fed estimates that so far about 80% of the increase in NOW accounts since the end of 1980 is related to shifts from demand deposits to NOW accounts. (The Fed is assuming that for the remainder of the year, 67% of the increase in NOWs will result from such shifts.) Thus, the actual target growth ranges are lower for M1-A (minus 4½% to minus 2%) and higher for M1-B (6%-8½%). This suggests that both measures are currently well below the lower bounds of their target ranges. And this probably explains the recent decline in the federal funds rate.

Chairman Volcker noted, however, that these adjustments in the monetary growth target ranges were tentative. Recognizing this, many financial market participants have posited that the Fed may place greater weight on the behavior of one of the broader money measures in formulating policy. Unfortunately, Chairman Volcker did not reveal the relative weights the Fed plans to attach to each of the different growth targets for the various monetary measures. Thus, if the growth rates of the various money measures begin to diverge by more than is suggested by their target ranges, it may be difficult to predict the likely monetary policy response.

It does appear, however, that the Federal Reserve's money growth targets would, if attained, constitute a tight monetary policy. The historical behavior of velocity—the ratio of current-dollar GNP to the money supply—suggests that it would take an abnormally large jump in velocity growth for current-dollar GNP to exceeed 9½%-10%, even if money growth were at the upper end of its target range. Thus, as Chairman Volcker noted, unless inflation abates significantly, the Fed's money growth targets would be consistent with only minimal real growth.

Reagan Grapples With Competing Doctrines

The Reagan administration's proposals to spur economic recovery while dampening inflation draw on several theoretical constructs: supply-side economics, rational expectations, and orthodox conservatism. So far, none of these economic theories has dominated the administration's policy formulation. But as the fight in Congress over the proposals intensifies, the new administration's priorities will ultimately crystallize. And this clarification will determine which items on the agenda will be subject to compromise in the legislative arena.

The *supply-side* camp has succeeded in sustaining President Reagan's commitment to the three-year, 30% Kemp-Roth tax cut for individuals and faster depreciation for businesses. The rationale is that such cuts will encourage more Americans to work harder and save more, while spurring businesses to invest more. The net result would be increased capital formation and large increases in economic output. But there is doubt among many economists that the magnitude of response to the tax cuts would be as large as supply siders claim.

Arguments by *orthodox conservatives* are guided by their concern about the size of the budget deficit. Their fears that large tax cuts—without offsetting budget cuts—would widen the deficit led to significantly smaller proposed increases in nondefense spending. Conservatives view deficits as inflationary because of the government's temptation to lean on the Federal Reserve to allow an accommodating increase in the money supply. But the budget is not projected to be in balance until fiscal year 1984, and even then only by a slim $500 million.

The *monetarists* contend that there is no direct connection between inflation and the size of the budget deficit. Their emphasis is that steadfast pursuit by the Federal Reserve of sufficiently low monetary growth can limit, if not eliminate, inflation. But if the Federal Reserve sticks to a highly restrictive course, realization of the rapid economic growth that the Reagan team projects would be unlikely.

Adherents to the *rational expectations* approach hold that what is most important is that the mix of policies be viewed as credible and stable—and able to achieve their desired goals. Believers in this theory maintain that the Reagan package would lower inflation expectations quickly and allow the forecast economic growth. But the speed with which this could be attained is debatable (see article on page one).

If in the coming months the financial markets judge the Reagan policies (as amended by Congress) harshly, or if the economy fails to perform as expected, a new policy mix is likely to be sought. A revised formula would most probably include new initiatives for further budget cuts and/or efforts to scale back or delay tax cuts.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars February 25, 1981	change from year earlier	current monetary conditions	
Argentina	Exports and agriculture to benefit from faster exchange devaluation; large grain harvest expected.	June	— 16%	102.1	$3,825	Oct.	7,804	— 15%	10.4	0	Peso devalued 10% last month.	Jan.	+ 84%	Oct.	+105%	.000525	—11%	Domestic interest rates rising.	**Argentina**
Bahamas	Proposals to control foreign investment in real estate under study.	June	+ 15%	1.1	4,590	Dec.	92	+ 19%	0.1	0	Tourist visits down slightly.	Nov.	+ 13%	Sept.	— 1%	1.0100	+10%	International reserves in decline since mid-1980.	**Bahamas**
Bolivia	Subsidies for many goods abolished or reduced; gas and food prices raised substantially.	Sept.	+ 21%	4.8	889	Dec.	106	— 41%	1.5	80	Commitment to austerity should improve external-payments position.	Nov.	+ 51%	Oct.	+ 44%	.0425	+ 4%	Credit is restrictive.	**Bolivia**
Brazil	Rise of public-service charges and price decontrol may boost inflation rate temporarily.	Dec.	+ 32%	204.7	1,725	Sept.	5,308	— 43%	2.5	0	Oil import volume reduced.	Jan.	+111%	Dec.	+ 71%	.0150	—33%	Local interest rates freed.	**Brazil**
Chile	Preliminary data show 6.5% real GDP growth last year; construction led with 17% gain.	Nov.	+ 9%	20.6	1,860	Dec.	3,123	+ 61%	6.1	123	Current-account gap widened to $1.6 bn. in 1980 from $890 mn. in 1979.	Dec.	+ 31%	June	+ 65%	.0270	+ 5%	Net foreign assets rising.	**Chile**
Colombia	Foreign direct investment rose more than $1 billion last year, led by coal mining projects.	Oct.	+ 16%	28.2	1,070	Dec.	4,831	+ 26%	12.3	0	Current-account surplus reduced because of lower coffee prices.	Nov.	+ 26%	July	+ 19%	.0225	0	Domestic bank credit increases sharply.	**Colombia**
Costa Rica	Fiscal and balance-of-payments positions deteriorating.	Nov.	+ 12%	3.9	1,760	Nov.	108	+ 14%	0.9	57	Exchange rate unified; local dollar futures market launched.	Oct.	+ 18%	Oct.	+ 8%	n.a.	—	Liquidity is tight.	**Costa Rica**
Ecuador	Emergency economic program boosts domestic oil-product prices by 200%-300%.	May	+ 47%	8.6	1,064	Dec.	1,066	+ 48%	5.6	0	Higher prices boost oil export earnings.	Nov.	+ 15%	Sept.	+ 29%	.0365	— 9%	New limits placed on credit expansion.	**Ecuador**
El Salvador	Wage and price controls imposed to reduced 125% inflation rate.	Sept.	+ 3%	3.5	750	Dec.	78	— 45%	1.0	[illegible]	Import restrictions imposed and foreign-exchange restrictions tightened.	Oct.	+ 17%	Oct.	+ 12%	n.a.	—	Net foreign assets declining.	**El Salvador**
Honduras	Real economic growth slowed to about 2% in 1980 from 7% in 1979.	Aug.	+ 4%	2.1	579	Oct.	152	— 5%	1.7	15	Coffee output drop of 15% hurt export growth last year.	July	+ 21%	Sept.	+ 8%	.5010	0	Some capital flight apparent.	**Honduras**
Mexico	Economic activity brisk, but industrial output rate declining because of capacity constraints.	Oct.	+ 73%	121.3	1,749	July	2,466	+ 26%	1.4	0	Non-oil exports growing slowly.	Nov.	+ 29%	Mar.	+ 48%	.0435	— 1%	External public debt reached $34 billion in 1980.	**Mexico**
Nicaragua	Real GDP advanced 14% last year, substantially less than hoped for by authorities.	Dec. '79	— 5%	1.7	660	Nov.	85	+ 42%	4.5	49	Agriculture and exports hurt by expropriation fears, labor and credit shortage.	Dec. '79	+ 68%	Aug. '79	+ 55%	.1015	+ 2%	Credit is scarce.	**Nicaragua**
Panama	Buoyant investment spending contributed to 5% real GDP growth in 1980.	Sept.	+ 21%	2.8	1,469	Nov.	80	— 28%	1.0	23	Current-account gap widening, owing to trade deficit.	Oct.	+ 14%	Sept.	+ 26%	Par	—	Credit growth is steady.	**Panama**
Paraguay	Economic activity steps up sharply, paced by large hydroelectric projects.	Oct.	— 6%	3.4	1,144	Dec.	762	+ 25%	14.7	0	Timber exports increase significantly.	Oct.	+ 17%	Oct.	+ 20%	.0080	0	International reserves rise strongly.	**Paraguay**
Peru	Real economic growth estimated at 3% in 1980, well below government target of 5%.	Sept.	0	13.0	752	Nov.	1,922	+ 63%	8.2	474	Trade surplus totaled $1 billion last year, down from $1.4 billion in 1979.	June	+ 54%	May	+ 88%	.0029	—25%	Interest rates increased.	**Peru**
Trinidad & Tobago	New discoveries of natural gas supplement the country's petroleum resource potential.	Sept.	+ 56%	4.5	3,945	Dec.	2,780	+ 30%	11.2	0	Current-account surplus enlarged by oil sales.	Oct.	+ 17%	Sept.	+ 23%	.4200	0	Credit demand is strong.	**Trinidad & Tobago**
Uruguay	Inflation cut to 43% in 1980, largely the result of slowdown in devaluation pace.	June	+ 16%	6.9	2,372	Oct.	416	+ 30%	3.2	0	Exchange-rate policy calls for 6% devaluation of peso by May.	Oct.	+ 58%	Sept.	+ 32%	.1005	—14%	Net foreign assets rising.	**Uruguay**
Venezuela	State holding company publicizes its decision to sell some 40 companies to private sector.	Aug.	+ 44%	48.9	3,619	Dec.	6,581	— 10%	7.3	0	Official authorizations of foreign investment doubled to $420 million in 1980.	Oct.	+ 23%	Sept.	+ 14%	.2335	0	International reserves declining.	**Venezuela**

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World Interest Rates

market rates of Feb. 25, 1981; bond yields as of Feb. 20, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty-large banks 16.00	17.14	14.00	12.00	9.50	7.50	16.50 penalty rate 19.50	8.00	3.50	7.25
Day-to-Day Money	14.875 Feb. 26	18.00	14.50	8.55	11.25	17.00	17.50	9.00	3.25	8.5625†
Treasury Bills 91-day, Middle Rates	14.16	16.80	12.00	12.75	n. a.	n. a.	15.30 64-day	no dealing	no market	5.875† 2-month
Commercial Paper prime, 3-month, asked	14.00 finance paper	17.00 finance paper 15% tax w/h	12.184*	11.50 Certified	12.875 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.65	16.90 15% tax w/h	12.625*	11.80 Certified	not traded	9.90	19.65	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	12.56	13.95	13.67	11.46 20% tax w/h	14.20	9.97	16.55	11.03	4.99	8.33
Industrial Bonds prime, long-term, new and old issues, average yield	13.55 Aa Industrials	14.25	14.15	15.49	15.19	10.06	17.02	11.69	6.10	7.01
Bank Short-Term Rate to Best Borrowers (prime rate)	19.00	18.25	15.00	15.50	13.85	12.25	21.00 ⅛ quar'ly fee on outstdng.	11.00	6.00	7.50†
Bank Time Deposits 3-month	14.875 Cert. of Dep.	16.25	12.50	13.00	13.00	12.75	10.75	10.375 large deposits	7.50 residents only	5.00† 20% tax w/h
Eurocurrencies 3-month, asked	16.875	no market	12.50	no market	13.25	14.75	no market	10.50	8.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8333	2.2300	.028935	.2020	.4732	.00098	.4278	.5201	.004817
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.50 *D*	4.00 *P*	3.00 *P*	3.00 *P*	2.50 *P*	2.25 *D*	6.25 *P*	7.00 *P*	7.375 *P*

Eurodollar Deposits
(London, interbank, bid)

	Feb. 26
7-day	15.125
1-month	16.00
3-month	16.5625
6-month	16.5625

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	n.a.
U.S.-Canada Treasury Bills	−1.15
U.S.-Canada Finance Co. Paper	−2.27
Eurodollars-U.K. Local Auth. Deposits	n.a.

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.25
Over 7 yrs.	14.50
DM Bonds	
7 yrs. and under	10.50
Over 7 yrs.	10.25

Gold Price

London
afternoon fixing

500.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of Feb. 10. † Market rates as of Feb. 18.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	11.7 (Jan.)	12.0 (Jan.)	13.0 (Jan.)	12.8 (Jan.)	5.8 (Jan.)	21.1 (Dec.)	5.1 (Jan.)	7.3 (Jan.)
Industrial production*	−0.6 (Jan.)	−1.7 (Nov.)	−10.9 (Dec.)	−2.2 (Dec.)	−5.6 (Dec.)	−3.8 (Dec.)	4.0 (Sept.)	3.9 (Dec.)
Trade balance† *(billions of local currency units)*	−$2.98 (Dec.)	C$0.50 (Dec.)	£0.76 (Jan.)	−FF8.40 (Jan.)	DM1.01 (Dec.)	−Lit.1,300 (Dec.)	−SF0.39 (Jan.)	−¥292 (Jan.)
Money supply (M_1)*	4.1 (Dec.)	8.5 (Dec.)	1.6 (Oct.)	8.3 (Oct.)	6.0 (Nov.)	15.9 (Sept.)	−7.4 (Oct.)	−1.6 (Nov.)
Velocity of money (M_1)*	4.6 (Dec.)	10.7 (June)	8.7 (June)	n. a.	3.0 (Sept.)	6.6 (Sept.)	n. a.	12.6 (Sept.)
Reserves minus gold *($ million, change from previous month)*	1,090 (Dec.)	565 (Dec.)	−813 (Dec.)	−1,240 (Dec.)	−240 (Dec.)	131 (Dec.)	2,921 (Dec.)	328 (Dec.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

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Oil Windfall Boosts Algerian Economy

Algeria's economic planners have been given new breathing room in the form of the recent surge in oil and gas prices. Average prices for Algerian hydrocarbon exports last year, which account for 98% of export earnings, were up 77% over 1979. The windfall bolstered Algeria's weakened financial position and gave its authorities the flexibility to cut oil output and boost imports, yet still erase a current-account deficit and ease the country's high debt service burden.

The increased oil earnings have led the government to push new oil and gas projects into the future to preserve resources, and focus greater attention on agriculture. Higher agricultural productivity is seen as vital for a sector that employs nearly half the population and in the face of a soaring food import bill. Nonetheless, the hydrocarbon sector will continue to dominate Algeria's economy—although it generates only about 1% of total employment. The rapid growth in export earnings projected through the early part of the next decade will provide the financial resources for both industrial and agricultural investment. The acid test, however, will be Algeria's ability to develop a strong non-hydrocarbon productive base to drive economic growth when its hydrocarbon earnings begin declining.

Characteristics of the economy

Algeria is generally regarded as a high-absorbing member of the Organization of Petroleum Exporting Countries, owing to its large population (19 million) and its ambitious development goals. The economy has been characterized by high levels of investment (50% of GDP in 1979) and heavy demand for imports, mainly capital goods and raw materials. The country's balance of payments has accordingly been weaker than the lower-population members of OPEC, and it has borrowed heavily in world financial markets. Its development strategy has consisted of austerity in consumption to permit rapid exploitation of hydrocarbon resources and heavy investment in manufacturing, transportation, and communications.

The hydrocarbon sector is clearly the star of Algeria's $25-billion economy; the sharp oil price gains of 1979 boosted the contribution of oil and gas to GDP to an estimated 40% from 28% as recently as 1978. Yet by OPEC standards, Algeria is far from being a major producer. Crude oil output has been relatively stable at 1.0-1.2 million barrels per day, and is currently running 900,000 bpd with exports of some 790,000 barrels. Moreover, petroleum resources are limited. Proven reserves are put at 8.4 billion barrels, sufficient to last 25 years at present output levels.

The country's greater wealth lies in its substantial reserves of natural gas. Proven reserves are 132 trillion cubic feet—the fourth largest in the world. Exploitation to date has been relatively minor, but development plans envisage heavy investment in LNG facilities and, more recently, in more cost-efficient pipelines to Europe—despite the recent cutback in investment plans and reduced export targets. The Algerians are pushing hard for price equivalence between their petroleum and natural gas exports. In fact, exports of LNG to France and the United States were interrupted for several months last year and still have not resumed to the United States. (Algeria initially sought $6.11 per million BTUs f.o.b., but the negotiating range is currently $4.00-$4.50.)

Apart from oil and gas, Algeria has managed to establish an adequate domestic manufacturing base. The manufacturing sector contributed 13% to GDP and provided 16% of employment in 1979. And it is well diversified among food products, heavy industry, textiles, chemicals, and construction. Heavy industry received strong emphasis in the 1970s, and industrial output rose 13.6%, on an annual average basis, between 1974 and 1977.

Despite real gains in output, the agricultural sector lost ground in the 1970s. The decade witnessed an agrarian revolution in which property was distributed to landless peasants and organized into production cooperatives. But until only recently, agriculture received diminishing attention from the government. It currently contributes only about 7% to GDP, while employing 43% of the population. Although food production did exceed population growth in the 1970s—owing to the government's emphasis on import substitution—rapidly rising incomes and a national birth rate of over 3% stimulated demand even more, causing food imports (mainly of wheat) to grow strongly. The 1979 food import bill was $2 billion, equal to more than 20% of total export revenues.

Despite Algeria's political leanings toward the Third World and Eastern Bloc, its economy is tied to the West. In 1979, the European Economic Community countries purchased 37% of Algerian exports and the United States, 53%. And import data show that France, Germany, Italy, and the United States satisfy nearly 60% of Algeria's total import needs.

Algeria's average annual economic growth was 6%-7%, adjusted for inflation, for most of the 1970s, with nominal GDP soaring more than 50% in 1974 when oil prices quadrupled. The fast growth was fueled by rapidly rising oil revenues and returns from high levels of productive investment in manufacturing, construction, and agriculture.

But the gains were not achieved without a build-up

Oil Windfall Boosts Algerian Economy *(continued from page 7)*

of inflationary pressure. Official consumer price data point to an annual average inflation rate of 10.4% between 1973 and 1979, with the rate peaking at over 17% in 1978. And these figures understate underlying inflationary pressure because of the prevalence of controlled prices—especially for food.

Despite the size and growth of hydrocarbon earnings, Algeria's balance of payments has been consistently weak. High export revenues have been more than offset by high imports associated with growing investment spending and food imports. A current-account surplus was achieved in 1974 following the oil price explosion, but spending rose steadily, and by 1978 the current-account balance was in deficit by $3.5 billion. The deficit narrowed slightly to $1.7 billion in 1979, owing to soaring oil and LNG export earnings and to reduced import growth stemming from reduced investment and import restrictions.

Algeria has financed its external-account deficits with substantial long-term borrowings by the public sector, supplemented by long-term project-specific export credits. The Euromarket has been the major source of the financings. The heavy Euromarket borrowings, which eased only as recently as 1979, permitted a steady growth in official reserves. By the end of 1979, foreign-exchange reserves reached $700 million, with official reserves at $5.4 billion, enough to finance over eight months of imports. But the sustained large borrowings also raised total disbursed external debt to $15.5 billion at the end of 1979. Debt service requirements rose to $2.6 billion in 1979, versus $1.5 billion in 1978, pushing the debt service ratio up to 26% from 22% in 1978.

The economy in 1980

Economic developments in Algeria last year were dominated by the impact of the sharp rise in oil prices. The average contract price for a barrel of Algerian Saharan 44° was $37.40, compared with $21.10 in 1979. This dramatic increase allowed the authorities to cut oil output to 1.0 million barrels per day last year from 1.14 million bpd in 1979 and reduce LNG exports, yet still realize an estimated $14 billion in hydrocarbon export revenues (versus $9.3 billion in 1979). The large revenues permitted a slight relaxation of import controls to alleviate the chronic shortage of consumer goods. This spurred a 28% jump in imports, which totaled an estimated $10 billion. But despite the import jump and a rise in interest payments on foreign debt—to about $3.3 billion—a balanced current account appears to have been attained after five years of deficits. And the strong export earnings reduced the country's debt service ratio from 26% to a more manageable 22%. Overall, real economic growth is estimated at a low 3% in 1980, owing to the impact of the cut in hydrocarbon output.

The near-term outlook

The 1980-84 development plan provides some indication of the authorities' change in the emphasis of development policy. The plan projects expenditures of about $15 billion a year (in 1979 prices), equivalent to 45% of annual GDP. It is still heavily biased toward industry (39%), although hydrocarbon expenditures will decline by the end of the period as major projects are completed. Agriculture is targeted for 12% of total plan investments, a share that is comparable with the previous plan, but implementation, which has been poor in the past, is expected to be rigorous this time.

The balance of payments is projected to perform favorably through 1986. The reasons include continued strong hydrocarbon prices and major output increases of LNG and LPG, in addition to new gas pipelines coming on stream. Hydrocarbon exports are forecast to grow from some $14 billion last year to over $44 billion in 1986. Even allowing for a major increase in imports, the current account is likely to post small annual surpluses through 1986.

Algeria is expected to return to the international capital market in 1981 and onward, largely to roll over maturing debt. And whenever feasible, it is expected to take advantage of export credits granted by foreign governments at preferential rates. Debt servicing requirements are projected to reach $5½ billion by 1986. But the huge growth of export earnings is expected to produce a steadily declining debt service. The ratio is expected to drop from its peak of 26% in 1979 to some 12% by 1986, implying an increasing ability to raise external finance.

A strong real economic growth performance is also anticipated for the next few years—averaging more than 8% per annum. Hydrocarbon output should be bolstered by a new gas scheme coming on line, and large returns are likely from the historically high investment level, which will be sustained during the plan period.

In sum, oil profits have made Algeria's economy viable. And the financial strength of the hydrocarbon sector will more than compensate for structural weakness elsewhere. Beyond 1986, the growth of export revenues is projected to slow, however, as will import growth. And in the mid-1990s, hydrocarbon export revenues are expected to begin declining unless new discoveries are made. Thus, the challenge to Algerian planners is to achieve broad-based industrial, agricultural, and infrastructural development sufficient to sustain real economic growth when hydrocarbon earnings peak.

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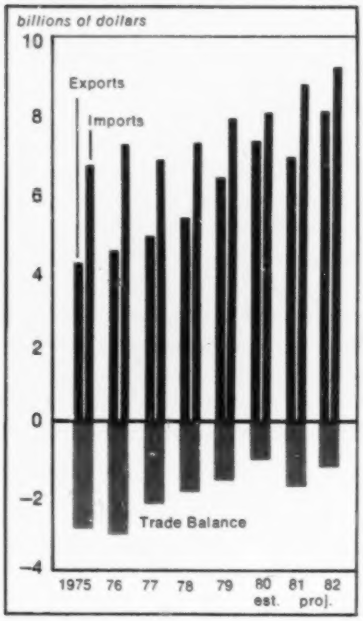
Polish Trade Deficit Expected to Widen in 1981

Polish national income declined by 4% last year, the result of widespread labor unrest—which toppled many Party and State leaders—and a sharp drop in agricultural output. Work stoppages and supply disruption caused industrial production in the second half of 1980 to fall 6% below the level prevailing earlier in the year; for the full year, industrial output fell 1.3%. While many important sectors saw production declines after mid year, the impact was particularly severe in coal and was accentuated by changes in work rules following fatal accidents in the mines. Average monthly coal production was 14 million metric tons in the last four months of 1980, well below the 17-million-ton monthly average for the first eight months.

The major blow to Poland's economy in 1980, however, was a disastrous harvest. Crop production fell 15.2% and meat output declined 4.5%. Grain production was up 7.2% from its low level in 1979, but there were major failures in potatoes and in sugar beets. Severe shortages of potatoes and other fodder crops diminished livestock inventories sharply. It now appears that two favorable harvests will be needed to restore livestock numbers and meat production.

Polish trade with non-Socialist countries



An excellent export performance in the first half of 1980 promised a dramatic improvement in Poland's trade balance with the West. But labor troubles in the second half reduced annual export volume by 4.3%. The drop in import volume, primarily the result of transport problems, was a more moderate 2.8%. Still, export revenues in the first half enabled Poland to cut its overall trade deficit with non-Socialist countries nearly in half—to approximately $875 million. The trade balance with Socialist nations shifted into a $1 billion deficit last year, after a small surplus in 1979.

Forecasts of Poland's trade performance in 1981 depend in large part on assumptions about the likelihood of an internal political settlement without a Soviet military intervention. The assumptions here are that the Polish Party Congress, scheduled for the end of this month, will approve a three-year stabilization program acceptable to both workers and peasants; that living standards remain at their current reduced levels; and that investment drops by another 5% this year after a 10.5% contraction in 1980. Under these conditions, and given the further decline anticipated for industrial and animal product output, export volume is forecast to fall by 10% in 1981. Consequently, Poland's hard-currency trade deficit is likely to widen to $1.8 billion.

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U.K. pursues greater convergence of fiscal and monetary policy.

Over the last two years, the British government has been criticized for combining a restrictive monetary stance with a lax fiscal stance. The new U.K. budget represents a determined effort to redress the imbalance. The government has announced a target growth band of 6%-10% for the sterling M3 money stock following last year's target of 7%-11%, but the new band is based on the money supply in February 1981—a month in which M3 lay well above last year's target. Consequently, the new target band constitutes a relatively easy monetary policy. In contrast, the government has budgeted for a huge increase in its tax revenues by raising indirect taxes on gasoline, alcohol, and tobacco and by failing to index income-tax brackets to account for last year's inflation. As a result, the 1981 budget deficit, which looked set to reach 14 billion pounds, is now projected at £10½ billion. The new monetary and fiscal policy mix is expected to boost the rate of inflation somewhat, and an average of 12% is now projected for 1981. The budget should nonetheless provide some scope for a reduction in interest rates and a resulting softening of the exchange value of the pound. Such changes —which have started with the announcement of a cut in the Bank of England's minimum lending rate to 12% from 14%—may give some boost to the economy this year. But they will not be large enough to offset the deflationary impact of the budget. Thus, another decline in GNP is expected in 1981, after last year's contraction of some 2½%.

Canadian GNP turnout in 1980 surprised forecasters.

Contrary to nearly all forecasts, Canadian real GNP ended 1980 with growth of 0.1%. A major reason for the stronger-than-expected level of economic activity was an export surge that brought about a decline in the goods and services deficit in real terms. This provided the Canadian economy with a 2.5% increase in final demand last year, compared with a 1% gain in 1979. Domestic demand in 1980 was also bolstered by unexpected strength in consumer and investment spending. Nonetheless, the growth rate last year was barely positive, with declines registered in inflation-adjusted durable goods sales. For 1981, the consensus forecast calls for real GNP growth of 1%-2%. This is contingent on a U.S. economic recovery and a possible deceleration of inflation and interest-rate pressures in both the United States and Canada.

Swedish strategy seeks reduction in inflation and oil-import dependence.

Recent events indicate that Sweden is making progress toward resolving important structural problems. In agreeing to an average wage rise of 7.1% spread over two years, Swedish workers have settled for pay increases that are well below the current rate of inflation. (The year-over-year rate in January was 13.1%.) The wage pact contains an escalator clause that triggers further pay rises should inflation exceed expectations, but as the negotiators agreed to exclude oil prices from their calculations, chances are that the clause will not be activated. The wage agreement has led the Economics Ministry to revise its 1981 inflation forecast down to 9% and to predict a slight climb in GDP during the year. Looking to the longer term, the government has put forward a program to reduce oil imports from 26 million tons per year to between 14 million and 17 million by 1990. This despite the halt to the development of nuclear power decreed in the referendum of March 1980. The foreign-exchange market has reacted favorably to these developments, and the heavy selling pressure suffered by the kronor earlier this year has now evaporated.

Finnish economy is one of Europe's strongest, but inflation and trade problems have emerged.

Finland is still likely to be one of the few European countries that will record positive economic growth this year, but its economic performance otherwise is converging with the European average. The Finnish inflation rate was a full 3% below the European average in 1979, 2½% below it in 1980, and it is expected to exceed the average in 1981. The acceleration of inflation and higher oil prices have created international payments problems similar to those experienced elsewhere in Europe. The balance of trade worsened from 1.2 billion markkaa in 1979 to 5.85 billion markkaa last year. And higher interest charges on external debt—which now stands at 16% of GDP—helped widen last year's current-account deficit to 5 billion markkaa from 0.8 billion in 1979. Despite these adverse trends, prospects remain reasonably good, and Finland should be able to avoid the full force of the European recessionary tilt by stepping up its exports to the USSR—from whom it obtains its oil supplies.

Japan's sluggish economy and reduced inflation suggest monetary easing.

Japan's economy continues to be sluggish, with weak consumer spending acting as a drag. Preliminary figures indicate that the unadjusted industrial production index rose just 3.6% in January from its year-earlier level, and corporate bankruptcies reached a record for the month. Year-over-year increases in January for the consumer and wholesale price indexes, however, moderated to 7.4% and 6.7%, respectively. All of this suggests that some relaxation of monetary policy is possible, especially to stimulate consumer spending. Furthermore, the expected appreciation of the yen should cushion the impact on prices of such a move. The questions faced by Japanese policymakers, however, are whether monetary easing can occur without rekindling fears of inflation and whether further appreciation of the yen should be permitted, given the already weak prospects for Japanese exports.

Economic growth in Singapore to stay brisk in 1981, with inflation relatively moderate.

Real GDP growth in Singapore accelerated to 10% last year, up from 9.3% in 1979. Fueled by strong demand for their services and products, the financial and construction industries supplanted manufacturing's position as the leading sector. With internal demand growing faster than domestic exports, Singapore's current-account deficit widened to about $2 billion. But inflows of investment capital more than filled the gap. Consequently, the Singapore dollar appreciated considerably last year, and the rate of consumer price inflation was held below 7%. The outlook this year remains favorable. Economic growth will probably slow somewhat to 8%-9%, but it is expected to be more balanced. The Singapore dollar's appreciation may ease, but declining world inflation should limit the rate of price increase to 6%-7%.

Colombian economic plan aimed at export diversification.

The Colombian economy is poised for strong growth over the next few years, largely because of the expected returns to the country's $20-billion National Plan of Economic Integration. Real economic expansion of some 5% is projected for 1981, up from 4% in 1980, with the growth pace rising to 6% next year. The Plan, implemented just last year, calls for large investment projects in coal and nickel mining and in hydroelectric power, and it emphasizes industrial development and public works improvements. The momentum provided by the program's large undertakings should offset the slowdown in the coffee export sector—attributable to coffee price declines—as well as the weakness in such traditional industries as textiles. By 1983-84, substantial new export revenues are expected to be realized for coal and nickel, which will supplement the sometimes volatile foreign-exchange earnings from Colombia's traditional exports. The new projects should also provide a broader base for sustained economic growth and income gains in Colombia over the longer term.

Lead price weakness forecast, largely the result of lagging auto demand.

Lead prices in 1981 are not expected to rise very much from their mid-January level of 32.1¢ per pound, owing to weak demand, particularly from the automobile sector. World demand is likely to be relatively flat this year, as high interest rates, rising oil prices, and economic recession dampen worldwide automobile sales. U.S. domestic auto production, for example, is projected at less than seven million units in 1981, compared with more than nine million units in 1977 and 1978. Non-Socialist world supply of refined lead is also expected to be flat this year, and inventories are likely to expand for the third consecutive year. Commercial stockpiles are forecast to rise by over 80,000 metric tons in 1981, pushing total inventories to the equivalent of some 1.1 months of consumption—their highest level since 1975. On balance, average lead prices are expected to be in the range of 34¢-36¢ per pound this year, which is well below the total cost of production.

Money Fund Surge Stirs Controversy

Net assets of money market mutual funds (MMFs) have jumped by almost $25 billion since the end of last year, and now total about $100 billion. This surge has intensified demands from some depository institutions that certain measures—such as imposing reserve requirements or limiting the check-writing feature of MMFs—should be taken to curb the growth of the money funds.

MMFs—or open-end investment funds that invest solely in short-term money market instruments—offer shareholders a highly liquid investment vehicle that yields a near-market rate of return. In contrast, commercial banks and thrift institutions are subject to regulatory restrictions on the interest rate they may pay on small deposits and transactions accounts. Moreover, many of these institutions must hold non-interest-bearing reserves against deposits—the equivalent of being assessed a tax on deposits. These differences, combined with the high level of market interest rates, are believed to be one of the major causes of the recent surge in MMF assets.

While the high interest rates of recent years certainly explain much of the *secular* rise in MMF assets, they do not explain *recent* behavior. For example, from last August to December, interest rates *rose* sharply while MMF assets *fell*. And from December to early March, rates *fell* while MMF assets soared.

A major reason for this somewhat paradoxical behavior is that MMF yields generally lag behind changes in market interest rates. This is because most MMFs amortize the return on each instrument held. For example, the current daily yield on a MMF may be based partly on the yield on 30-day commercial paper purchased up to 30 days ago. Thus, when market interest rates rose from last August to December, the yield on money market instruments (as well as that on six-month money market certificates at banks and thrifts) rose relative to that on most MMFs. And when market interest rates began to fall early this year, MMF yields rose relative to market interest rates. The behavior of MMF assets over the same period suggests that the *spread* between MMF yields and market interest rates—and not simply the level of market rates—has had a major effect on MMF asset growth.

An implication is that the imposition of reserve requirements on MMFs would—by increasing the cost of operating a MMF and thereby reducing its relative yield—depress the growth of MMF assets somewhat. However, to the extent that there are shifts among investment vehicles, the chief result would be an increase in direct investment in money market instruments, and not in consumer deposits at depository institutions.

Another Downturn for Housing

After a two-year slide, the rebound of housing construction that began last fall and continued into early winter surprised many analysts. Housing starts fell by 50% to an annual rate of 1.06 million housing units in the second quarter of last year, but residential construction activity regained one-half of this loss by the end of 1980. This pattern is in sharp contrast to the behavior of housing in the 1973-75 recession. Then, the drop-off in starts was only somewhat greater (60% peak-to-trough), but six months after the trough, the recovery was only half as fast. Sharp differences in the cost of financing and in the supply/demand balance in the housing market explain the different patterns between the current cycle and that of 1973-75; they also indicate that another downturn in housing activity is probable.

Despite the relatively high level of housing starts recently, signs of weakness have already appeared. Sales of new homes have fallen more than 10% in the last two months. And turnover of existing homes has tumbled by a quarter since its early-fall peak.

Interest rates are perhaps the most important reason for the current weakness of single-family starts. Rates went from 12% in January 1980 to 14% in May, down to near 12% again in August, and back up to almost 14% in January. In 1975, by contrast, mortgage rates dropped only about ½% from their peak. They then stood stable at this lower level for three years, allowing steady gains in construction and resale activity. Although there is evidence to indicate that homebuyers are becoming inured to higher mortgage rates, the combination of higher rates, reduced availability of loanable funds from thrifts, depressed resale activity, and still-rising house prices seems almost certain to push single-family starts even lower in the months ahead.

The multi-family segment is also set for a downturn. Multi-family starts were an important contributor to last fall's surge in housing starts. While starts of single family units fell 9% in the fall as mortgage rates rose, starts of multi-family units soared 40%. Extreme tightness in many local markets—reflected by a national vacancy rate for rental units of only 4.8%—and continuing support of governmental subsidies for low-income housing spurred new construction of apartments. In contrast, overbuilding of multi-family units in 1972-73 resulted in a vacancy rate above 6% in 1974 and 1975, and almost complete withdrawal of government subsidies depressed the normal cyclical recovery in apartment construction.

The current level of apartment building, however, is far below that of 1972-73, and the low vacancy rate indicates that speculative overbuilding is currently not a problem. Still, the high level of interest rates is likely to dampen multi-family starts at least somewhat. Moreover, the government subsidy programs, which are only about half their size in 1972-73, are scheduled to be trimmed by a quarter, or some 60,000 units.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
			6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes				exchange rate in U.S. dollars	change from year earlier	current monetary conditions	
													latest data	consumer prices	latest data	money supply(M1)	March 11, 1981			
Africa	Algeria	Real GDP growth was 3% last year, dampened by reduced oil production.	Nov.	+ 32%	24.6*	$1,374	Jan.	3,676	+ 35%	1.4	0	Hydrocarbon export receipts were $14 bn. in 1980, more than double 1979.	Dec. '79	+ 12%	Dec.'79	+ 18%	.2500	− 3%	European Invest. Bank lends $20 mn. for power stations.	Algeria
	Cameroon	New liberal investment code encourages private industrial investment.	July	+ 32%	5.0	650	July	194	+134%	1.4	9	Current-account gap could double to $300 million in 1981.	Aug.	+ 14%	July	+ 25%	.004104	−11%	Agricultural credits retain priority.	Cameroon
	Egypt	Western aid commitments for 1981 put at $2.95 billion, versus $2.5 billion last year.	June	+ 74%	16.4	400	Nov.	1,057	+189%	2.8	173	Twelve new oil discoveries reportedly made in Gulf of Suez last year.	Nov.	+ 19%	Nov.	+ 24%	1.45	0	Money supply expanding steadily.	Egypt
	Gabon	Oil output forecasts for 1981 lowered to 170,000 bpd, owing to delays in tapping new wells.	Dec.	+ 37%	3.8**	6,900	July	70	− 11%	1.3	14	Trade surplus in 1981 expected to approximate 1980's $1.8 billion.	May	+ 14%	July	+ 10%	.004014	−13%	Credit expansion within IMF ceilings.	Gabon
	Ivory Coast	Restrictive fiscal policy expected to continue through 1981.	May	− 6%	9.0	1,135	Oct.	19	− 91%	0.1	0	IMF approves $630-million, three-year credit line.	Sept.	+ 10%	June	+ 2%	.004014	−13%	Public enterprises step up bank borrowing.	Ivory Coast
	Libya	German and Austrian companies awarded $1.3 billion in contracts for steel projects.	Oct.	+ 36%	20.0*	7,270	Sept.	12,158	+135%	17.1	0	LNG exports to Italy cut off in January, owing to disagreement on price.	n.a.	n.a.	Dec.'79	+ 33%	3.42	—	Net foreign assets rising.	Libya
	Morocco	World Bank to lend $136 million for tourism and housing projects.	Sept.	+ 32%	15.3	788	Dec.	399	− 28%	1.3	309	Phosphate prices averaged $45 per ton last year, up 36% from 1979.	Oct.	+ 12%	Nov.	+ 7%	.2150	−15%	Swiss loan of $51 million obtained for industrial projects.	Morocco
	Niger	Anticipated reductions in uranium earnings cause cutbacks in investment plans.	Dec.	+ 21%	2.0	390	Jan.	244	+ 78%	2.5	0	Uranium price fall worsens balance-of-payments outlook.	Aug.	+ 11%	July	+ 27%	.004014	−13%	External borrowing set to rise.	Niger
	Nigeria	Capital budget for 1981 shows modest rise of 17% to $16.5 billion.	Nov.	+ 38%	54.6	700	Jan.	9,974	+ 79%	10.4	0	Imports surge in response to relaxed controls.	Mar.	+ 12%	Aug.	+ 15%	1.79	—	No further credit liberalization expected.	Nigeria
	South Africa	Manufacturing due for a leveling-off in output and sales; fixed investment to rise.	Dec.	+ 30%	57.3	2,070	Jan.	934	+ 40%	0.5	0	Current account moves into deficit as gold price stays below $500/oz.	Dec.	+ 16%	Nov.	+ 41%	1.2735	+ 3%	Interest rates expected to rise.	South Africa
	Tunisia	Real economic growth of 7% estimated for 1980, same as in 1979.	Aug.	+ 41%	7.0	1,096	Jan.	528	− 3%	1.7	0	Planned rise in public-sector investment to boost capital goods imports.	Sept.	+ 9%	Sept.	+ 17%	2.33	− 7%	Money supply expanding more rapidly.	Tunisia
	Zaire	High external debt service payments seen stifling economic growth.	Sept.	+ 45%	6.2	220	Dec.	204	− 1%	3.1	217	Official cobalt price cut to $20 per pound as demand falters.	Oct.	+ 25%	Sept.	+ 27%	.3425	+ 4%	Credit to government in 1980 was below planned ceilings.	Zaire
	Zambia	Low copper price deters mine expansion and maintenance.	Dec. '79	− 4%	3.2	572	Nov.	52	− 47%	0.8	377	Approximately $700 million arrears precludes access to essential imports.	June	+ 14%	Oct.	+ 2%	1.32	+ 8%	Foreign-exchange shortage near crisis level.	Zambia
	Zimbabwe	Real economic growth this year could exceed last year's 8%.	Dec.	+ 14%	3.9	530	Dec.	264	− 6%	2.4	0	Growth of metals exports slackens, while agricultural exports accelerate.	Dec.	+ 8%	Dec.	+ 34%	1.55	+ 2%	Measures to restrain excess liquidity introduced.	Zimbabwe
Middle East	Iran	Japanese to resume work on several projects.	Sept.	− 44%	n.a.	n.a.	June	15,478	+ 41%	n.a.	0	Oil output reported to be at least 1 million bpd; shipments to Japan resumed.	Nov.	+ 28%	Mar.	+ 32%	n. a.	—	Foreign-exchange reserves officially put at over $6 billion.	Iran
	Iraq	Rise of 29% in investment spending to $17.9 billion officially projected for this year.	Oct.	+ 31%	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0	Oil exports through Turkish and Syrian pipelines reportedly 900,000 bpd.	n.a.	n.a.	n.a.	n.a.	3.41	—	Credit generally available.	Iraq
	Saudi Arabia	Official consumer price index rose 3.1% in IV Q 1980, up from 2.0% in like 1979 period.	Nov.	+ 71%	74.8***	11,510	Jan.	25,072†	+ 35%	10.6	0	Price of "war-relief" crude of 500-700,000 bpd hiked to $36 per barrel.	Sept.	+ 4%	Oct.	+ 14%	.2990	—	Riyal revalued again to 3.35 per dollar from 3.34.	Saudi Arabia
	United Arab Emirates	Increased public-sector outlays will buoy private economic activity this year.	Nov.	+ 41%	13.8*	19,435	Jan.	2,400†	+106%	3.3	0	Japanese firms contract for 1.44 million tons per year of Abu Dhabi LPG.	n.a.	n.a.	Nov.	+ 16%	.2740	+ 2%	Bank credit to private sector expanding.	United Arab Emirates

*1978 **1980 ***1978/79

†Excluding state reserves

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World Interest Rates

market rates of Mar. 11, 1981; bond yields as of Mar. 6, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty-large banks 16.00	17.16	12.00	12.00	9.50	7.50	16.50 penalty rate 19.50	9.00	4.00	7.25
Day-to-Day Money	14.50 Mar. 12	18.00	16.00	7.80	11.50	11.75	17.50	10.25	3.75	8.4375
Treasury Bills 91-day, Middle Rates	13.84	16.85	11.75	13.75	13.65 one-year	n. a.	15.498 77-day	no dealing	no market	5.875 two-month
Commercial Paper prime, 3-month, asked	14.75 finance paper	17.10 finance paper 15% tax w/h	11.406	11.50 Certified	12.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.30	17.00 15% tax w/h	11.875	11.80 Certified	not traded	9.90	19.80	no market	4.50	no market
Government Bonds Long-term, new and old issues, average yield	12.57	14.00	14.02	11.476 20% tax w/h	14.425	10.41	16.71	11.80	5.45	8.23
Industrial Bonds prime, long-term, new and old issues, average yield	13.70 Aa Industrials	14.625	14.14	15.53	15.55	10.70	17.26	12.21	6.081	7.04
Bank Short-Term Rate to Best Borrowers (prime rate)	18.00	18.25	13.00	15.50	14.60	12.00	21.00 ⅛ quar'ly fee on outstdng.	12.50	6.00	7.50
Bank Time Deposits 3-month	14.75 Cert. of Dep.	17.00	12.625	13.75	12.5625	14.00	10.75	11.25 large deposits	8.5625 residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	15.6875	no market	12.50	no market	12.375	12.875	no market	10.875	8.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8344	2.2100	.02881	.2004	.4720	.000975	.4269	.5165	.004820
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.00 *D*	2.375 *P*	1.75 *P*	3.00 *P*	2.75 *P*	2.875 *D*	4.75 *P*	7.25 *P*	8.00 *P*

Eurodollar Deposits
(London, interbank, bid)
March 5

7-day	15.875
1-month	16.4375
3-month	16.625
6-month	16.625

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	— .124
U.S.-Canada Treasury Bills	−1.02
U.S.-Canada Finance Co. Paper	−1.12
Eurodollars-U.K. Local Auth. Deposits	n. a.

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.50
Over 7 yrs.	14.50
DM Bonds	
7 yrs. and under	9.75
Over 7 yrs.	10.00

Gold Price
London
afternoon fixing

476.25
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Pakistani Economic Indicators

	1977/78*	1978/79*	1979/80*	1980/81*	1981/82*
				projections	
Real GDP Growth, %	7.0	6.0	6.2	5.5	6.0
Inflation, %	8.0	7.0	14.0	13.0	11.0
M2 Growth, %	21.8	20.6	18.8	16.0	15.0
Trade Balance (million $)	−1,464	−2,170	−2,416	−3,050	−3,200
Current-Account Balance (million $)	−630	−1,127	−1,125	−1,720	−1,765
Reserves/Average Monthly Imports	3.0	1.2	1.9	1.1	1.0
Debt Service/ Current Account Receipts	.11	.13	.14	.13	.12

* Fiscal year runs July 1 through June 30.

IMF Aids Pakistani Restructuring

Despite the economic growth advances of recent years, Pakistan's economy remains highly vulnerable. Among its problems are chronic budget and balance-of-payments deficits, extremely low agricultural productivity, and heavy dependence on external finance. At the same time, however, recent policy actions by the Pakistani Government have inspired the confidence of the International Monetary Fund. The IMF's $1.73-billion, three-year Extended Fund Facility loan is one of the largest ever granted a developing nation. And if the Pakistani leadership adheres fairly closely to the conditions outlined in the IMF arrangement, the economy should improve its standing by the end of the EFF program period.

Substantial progress, but problems persist

The Pakistani authorities have instituted major policy changes since 1977 to improve economic performance. In agriculture, greater attention has been paid to improving producer incentives and augmenting the availability of input supplies. In industry, the policy of extensive nationalizations and sharp restrictions on private-sector activity instituted in the early 1970s has been gradually reversed. Some spheres of activity previously closed to the private sector have been reopened, several public-sector enterprises have been returned to private hands, and a wide range of incentives have been introduced to spark private initiative. Attempts have been made to reform the remaining public-sector enterprises and to increase tax revenues. Subsidies have been reduced, incentives introduced to stimulate exports, and steps taken to lessen dependence on imported oil.

The economy has responded well to these measures. Inflation-adjusted economic growth averaged 6.4% in the period 1977/78-1979/80, more than double the annual population growth rate of 3%. Over the same period, agricultural output expanded by 4.2% on average, while manufacturing grew by an average 7.4% per annum, compared with annual growth rates of 1.6% and 2.8%, respectively, for the 1970/71-1976/77 period.

In fiscal 1979/80 alone (ended June 30, 1980), the Pakistani economy posted real growth of 6.2%. Agricultural production increased 6%, owing to strong cotton and wheat crops, and industrial output rose by 8.1%, fueled by improvement in the textile industry. On the external side, exports jumped 42% while import growth was held to 25%, leaving the country's current-account deficit virtually unchanged from the previous fiscal year's $1.1 billion.

Although this strong growth scenario would seem to imply that the shifts in policy achieved a solid economic rebound, they have failed to overcome serious fundamental weaknesses in the economy. These include:

- a population growth rate that makes increases in per capita income difficult and aggravates unemployment;
- poor agricultural productivity, with continued excessive reliance on favorable weather;
- weak private investment stemming from bureaucratic red-tape, unfavorable labor laws, and continued political uncertainty;
- a low and stagnant savings rate;
- chronic budget deficits resulting from income-inelastic revenues, heavy subsidization, and the inefficiency of public-sector enterprises,
- high inflation (officially estimated at 10%-11%, but privately estimated at 15% or higher);
- chronic balance-of-payments deficits, despite strong exports, import restrictions, and substantial foreign remittances;
- heavy dependence on external finance and a large debt service burden; and
- reliance on imported oil for domestic energy needs.

Thus, although the steps taken so far have been in the right direction, Pakistan has far to go before it finds itself on a steady and sustainable growth path. The IMF's three-year, $1.73-billion loan was granted specifically to aid in the effort at economic restructuring. In return, Pakistan agreed to: reorient its public-sector investment program to stress quicker-yielding projects; take steps to improve the profitability of public-sector enterprises; further slash subsidies to reduce the public-sector deficit, and restructure the budget revenue system to make it more responsive to increases in economic activity. The authorities have also imposed ceilings on the expansion of credit to the government, on overall domestic credit expansion, and on external borrowing by the public sector. Finally, to spur production and exports, significant import liberalization is to be pursued.

Additional public expenditures arising from supporting about 1½ million Afghan refugees, general defense, and the government's commodity operations may make it difficult for Pakistan to meet the IMF conditions with regard to paring the budget deficit and reducing deficit financing. And the authorities may not succeed in cutting subsidies as fast as the IMF deems desirable, for fear of generating internal

IMF Aids Pakistani Restructuring *(continued from page 7)*

unrest. Nonetheless, with prudence, Pakistan should be able to approximate the IMF ceilings.

The domestic outlook to 1982

Pakistan is expected to record real GDP growth of some 5.5% in fiscal 1980/81. Agricultural output looks set to expand by at least 4%, paced by large gains in wheat and sugarcane production. And industrial output is projected to be up by nearly 8%, with increases in textile output and sugarcane refining. Overall industrial activity will be spurred by greater access to imported inputs to production in the second half. With the higher level of economic activity, the services sector is likely to record real growth of about 6%.

In fiscal 1981/1982, agricultural output could rise by another 4%, assuming favorable weather. Industrial activity should continue stimulated by the import liberalization and could expand by 8.5%. And if the pace of services sector growth rises to 6.5%, Pakistan may record real GDP expansion of about 6%.

The policy of import liberalization is also expected to contribute to an easing of inflationary pressures. Pakistan's inflation rate accelerated to about 14% in 1979/80. With the economy relatively closed by the import restrictions instituted in October 1979, the excess supply of money that resulted put upward pressure on domestic prices, rather than flowing out through the purchase of goods from abroad. However, as the economy opens up through import liberalization, inflation should ease to the world level. The rate is expected to drop to about 13% in 1980/81 and further to 11% in 1981/82, even in the event of a small devaluation.

External-account deficits will widen

Pakistan's balance of payments is likely to deteriorate this year and next. Exports of cotton and rice—which account for one-third of total export receipts—are forecast to increase by about 12% in 1980/81; exports of manufactures look set to rise by only 14%, owing to the worldwide recession. Textile exports will likely continue constrained by restrictive import quotas in the United States and Europe. Overall, exports are projected to increase by only 13%.

The outlook for imports is unclear. The oil import bill is expected to reach $1.5-$1.6 billion in 1980/81, up from about $1.1 billion in 1979/80. But a great deal of uncertainty surrounds the magnitude of non-oil import growth that will be triggered by the liberalization of import restrictions. Imports of consumer goods will continue to be restrained, and the removal of curbs on imports of raw materials, intermediate inputs, and capital goods will be gradual. Nevertheless, pent-up demand is likely to be unleashed, and total imports are expected to increase by perhaps 20% in value terms in 1980/81. A trade deficit of $3 billion is forecast, but continued strong inflows of remittances will reduce the current-account deficit to $1.7 billion. Still, this represents a sharp widening from the current-account gap of $1.1 billion registered last year.

Fiscal 1981/82 should see strengthened export growth. Exports of manufactures should pick up as the world economy climbs out of recession and as imported inputs become more readily available. (A devaluation would further bolster competitiveness.) Overall, export earnings are projected to rise by about 16%. Import growth, on the other hand, could be held to 10%, based on the expectation of slower growth in imports of oil, raw materials, intermediate inputs, and capital goods—after their anticipated surge in fiscal 1980/81. The trade balance, however, is still likely to be in the red by about $3 billion, with the current-account gap expected to remain at around $1.7 billion, essentially unchanged from 1980/81. The current-account and trade balances should improve in subsequent years as exports strengthen in response to the liberalization of imports (and a likely devaluation). And later in the decade, oil imports may be cut significantly as attempts to boost domestic production of oil and natural gas begin to bear fruit.

The prospect of large current-account deficits in fiscal 1980/81 and 1981/82 points to the need for additional external finance. Public and publicly-guaranteed external debt, which is estimated to have risen to about $9.8 billion at the end of 1980, is projected to rise to about $11 billion by the end of 1981. In mid-January, the Aid-to-Pakistan Consortium granted Pakistan about $270 million in debt relief to be drawn down over an 18-month period. Additional aid, probably from other Islamic nations, is projected at about $200 million this year, and short-term commercial borrowings of $36 million are expected. Nevertheless, Pakistan's already low reserves are expected to decline by about $200 million this fiscal year and still further in 1981/82.

The Pakistani authorities have taken the appropriate steps at economic restructuring, and competent economic management promises continued progress. But the economy remains fragile. A severe balance-of-payments crisis looms as a possibility. And it will be difficult to spur private-sector activity sufficiently until political uncertainty is reduced—which is problematic. The economy's performance will also continue to hinge on favorable weather. Still, if the authorities adhere fairly closely to the IMF program, serious balance-of-payment difficulties should be avoided and the foundation laid for steady and sustainable economic growth in the latter part of the 1980s. *Melanie L. Lau*

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U.K. Budget Squeeze Expected to Continue

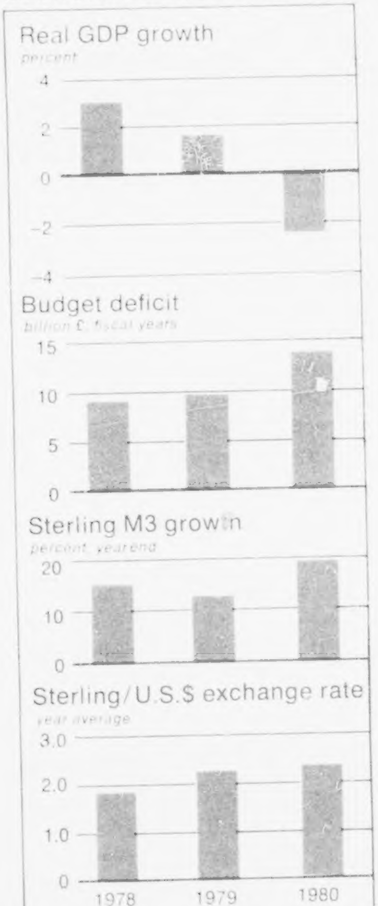
The Thatcher Government has now presented three budgets to the U.K. Parliament since its election in May 1979. The first two were severely deflationary, and many expected the 1981-82 budget to represent something of a change in direction. In fact, the overall policy stance of the new budget shows little change. It still gives priority to fighting inflation by means of monetary control.

The new budget does seek to redress the imbalance between fiscal and monetary policies, however. The government has been faulted for pursuing a tight monetary policy combined with a rather loose fiscal policy—evidenced by rising government spending and a huge budget gap. This combination tends to squeeze the private sector by boosting interest rates. This squeeze has been further aggravated by sterling's climb, which has eroded profit margins in the export sector.

The new 6%-10% target for money supply (£M3) growth—while lower than the previous range of 7%-11%—actually represents an easing of policy because it is based on February 1981, a month in which the money stock was well above target. On the fiscal side, the new public-sector borrowing requirement (PSBR) is targeted to be much smaller than last year as a result of rising personal tax revenues—which will once again squeeze the private sector—rather than reduced government spending. Indeed, the only hope of reflation is that a reduced budget deficit will allow lower interest rates and a lower exchange rate.

The government has begun the process of interest- and exchange-rate easing by cutting the Minimum Lending Rate to 12% from 14%. Further cuts may be made later this year. But the PSBR in 1981-82 will almost certainly exceed the budget forecast, thus leading to uncertainty over government funding tactics and the future course of interest rates. As for the pound, the initial effect of the budget has been to boost it. And although oil prices have softened somewhat, OPEC members are likely to decide to reduce supplies when they meet in May so that the "North Sea" effect may continue to buoy sterling. Furthermore, the ongoing recession will keep the balance on current account strong. Thus, while declining interest rates may lead to some fall in sterling, any weakness should be limited. If, as is widely expected, interest rates decline in the near term in the United States as well as in Germany and other European Monetary System member countries, the likelihood of reasonable sterling strength would be further enhanced.

Selected U.K. economic indicators



Belgium's new incomes policy should break the fast pace of wage increases.

Belgium has taken a much-needed step toward a sounder economic structure. The recently accepted incomes policy states that no wage increases will be granted in excess of automatic cost-of-living adjustments for new wage contracts for the next two years. Since 1973, real wages per wage earner have risen at a 3.4% average annual rate—compared with the European Economic Community average of 1.7%—and have far exceeded Belgium's 2.2% annual growth in labor productivity. This sharp climb in inflation-adjusted wages is largely responsible for the secular rise in unemployment—to 9.8% last year from only 2.4% in 1973. It has also squeezed profits in manufacturing, so that in 1979 the level of manufacturing investment in constant prices was 30% below the level prevailing in 1970. The impetus for agreement on the income policy was not concern over the distribution of income, but rather the growing current account deficit, which is expected to widen further from the $6 billion posted last year.

Portugal's new economic plan targets may be hard to hit in 1981.

The Portuguese authorities have unveiled an ambitious four-year economic program. The plan envisages average annual real GDP growth of 5% through 1984, with investment growth of 8%, and a drop in the inflation rate to 10%. It does, however, acknowledge the probability of a widening balance-of-payments gap. Economic performance in 1980 suggests that the plan's targets are not overly optimistic. Last year, economic growth of 4.7% was attained, with investment advancing by 8%, and inflation easing to 16.6% from 24.2% in 1979. Moreover, the current-account deficit in 1980 was $1 billion, only $200 million higher than officially forecast. A repeat performance in 1981, however, will not be easy. The worldwide recession is inhibiting export-led growth, and a drought has hurt agricultural output and hydroelectric power generation. Slower real GDP growth of 2.5%-3% is forecast for 1981, as is a widening in the current-account shortfall to $1.7 billion. In addition, underlying inflationary pressures are expected to push consumer price growth back up to 20%.

Israeli economic sluggishness last year did little to dampen inflation.

Israel's GNP grew, in real terms, by less than 1% last year, and unemployment reached more than 5% of the workforce by yearend. The economic slowdown did help narrow the civilian trade deficit to $2.6 billion from $3 billion in 1979, but the current-account deficit may have increased slightly, mainly the result of higher defense imports. The economic weakness last year had little impact on the country's rate of inflation, which reached 133% at yearend. This prompted Finance Minister Yoram Aridor to launch a fresh initiative to cut inflation and spur growth. The latest measures include a reduction in purchase taxes, the reintroduction of subsidies on energy and basic foodstuffs, and an easing in personal taxes. These are aimed at lowering inflation expectations and boosting economic growth, thereby permitting the government to recoup lost revenues. Short-term success in cutting the rate of price rise, however, will only be sustained over the longer term if the Israeli budget deficit can be reduced and monetary growth curtailed.

Taiwan's trade account was balanced last year, against all odds.

Despite an unfavorable trade climate last year, Taiwan—dependent on exports to the West and on imported oil—succeeded in balancing its trade account. Two-way trade expanded 28% from 1979 to almost $40 billion. Manufactured exports benefited from political instability in rival South Korea. In addition, growing demand for light industrial raw materials in the People's Republic of China caused exports to Hong Kong (as entrepot) to surge. The strong merchandise trade showing was offset, however, by a widening deficit on the invisibles account. Taiwanese tourists spent more abroad than foreign tourists in Taiwan, and outward transfers by Taiwanese nationals were large. As a result, the current account registered a deficit of about $1 billion, and foreign borrowing was stepped up to fill the gap. The external economic outlook for 1981 is uncertain. Although greater oil price stability is expected, lingering recession in Taiwan's major export markets and reviving Korean competition are worrisome. Even with the anticipation of some recovery in sales to the West in the second half of this year, a small trade deficit seems unavoidable. And with trends in invisibles unchanged, the current-account deficit is likely to widen.

Japanese government announces measures to spur lagging economic growth.

Responding to signs of unexpected economic weakness in the Japanese economy—real GNP advanced at a seasonally adjusted annual rate of only 2.[illegible]% in the final quarter of last year—the Japanese authorities announced a variety of measures to spur growth. The economic package is comprised of fiscal measures to aid small and medium-sized businesses, boost housing construction, and accelerate public works spending. But fiscal stimulation is limited, owing to the government's desire to reduce the budget deficit. The relaxation of monetary policy is more significant. The Bank of Japan cut its discount rate 100 basis points to 6.25%, lowered reserve requirements, and abolished restrictions on commercial bank lending for the second quarter of 1981. Interest rates on deposits are also to be cut. Banks have responded by slashing their prime rate 75 basis points. Despite these measures, however, the economy's inventory adjustment will not be completed before midyear, and consumer spending is unlikely to strengthen until after the spring wage increases. Thus, economic activity is not expected to pick up much before the third quarter.

Mexican economic growth eased slightly in 1980, but oil output and reserves jumped.

The rate of real GDP growth in Mexico slipped to 7.4% last year from 8% in 1979, the result mainly of a drop in manufacturing output. Manufacturing production was expanding by only 4.5% by October 1980, compared with growth rates of 8%-10% early in the year. Behind the manufacturing slowdown was excessively rapid growth of demand pressing up against available capacity, which led to materials shortages and transport delays. The demand pressures also helped push the rate of inflation to almost 30% by the end of 1980, compared with a year-earlier rate of 20%. Petroleum production, however, was up by more than 20% last year, and the level of proven reserves was boosted to 68 billion barrels from 60 billion barrels. GDP growth in the current year is expected to remain in the 7.5% range as the oil output rate continues to rise and as agricultural output improves in response to added investment.

Cameroon external-account outlook brightened by growing oil output.

Cameroon's three-year-old oil industry is expected to attain production levels of 80,000 barrels per day this year and 200,000 bpd by 1985. Rising oil export receipts, which are projected to hit the $1-billion mark this year, are especially fortuitous since the country's agricultural export receipts are depressed by low prices for its chief commodity exports, cocoa and coffee. With full production at the soon-to-be-opened Victoria refinery scheduled for 1982, imports of oil products could be virtually eliminated. As oil output rises, Cameroon could see a net surplus on oil account of about $900 million in 1982 and a surplus of almost $1.5 billion by 1983. Aided by increasing income on the services account from the expansion of the national air and shipping lines, Cameroon could eliminate its traditional current-account deficits by 1983 and enjoy surpluses thereafter.

Wheat price outlook bullish, with world supplies contracting once again.

Wheat prices are expected to rise substantially in the second quarter of this year, owing to tight supplies and growing demand. World wheat production is projected to reach some 442 million metric tons in crop year 1980/81, ending in June, compared with 422.2 million tons produced in 1979/80. But with world utilization expected to climb to about 450 million metric tons from 443.7 in 1979/80, ending stocks are expected to narrow to approximately 70 million metric tons in 1980/81 from 79.4 million tons a year earlier. Ending stocks of wheat as a percent of utilization are likely to drop to 16% in 1980/81—a substantial reduction from the last decade's carryover low of 17.3% recorded in 1972/73. The crop year 1980/81 will mark the second consecutive annual decline in total world wheat supplies. Prices for Kansas City "No. 1 hard red winter" wheat are thus expected to approach $5 per bushel in the second quarter of calendar 1981. Prices are then expected to ease in the second half of the year after the 1981/82 wheat crop is harvested—barring shortfalls created by adverse weather.

Bears in the Corporate Bond Market?

During the first quarter of 1981, corporations have moved to lengthen the maturities of their credit market liabilities. The volume of corporate nonconvertible bonds issued since the first of the year has approximated $7.5 billion, compared with $4 billion during the last quarter of 1980. Short-term credit (as measured by commercial and industrial loans at large commercial banks plus non-financial commercial paper) has increased only $1.5 billion over the same period, compared with an $8 billion increase during the fourth quarter.

This debt extension by non-financial corporations has occurred during a sizable decline in short-term rates, while long term rates have remained near record levels. For example, since the first of the year, the rate on 90-day Aa industrial paper has fallen 325 basis points, while the yields on new 7-year and 20-year Aa industrial bonds have both *increased* by 50 basis points.

This behavior by firms may, at first glance, seem paradoxical, given the financing behavior exhibited during the last upswing in both short- and long-term interest rates. During the last half of 1980, a sizable number of firms postponed issuing long-term debt, relying on temporary short-term financing until long rates began to decline. In contrast, long-term rates during the March rush to the bond market were at levels *above* those of November of last year, when the volume of new issues was one of the smallest on record.

One obvious explanation is a reversal of corporate expectations concerning the future path of long-term interest rates. The recent volume of financings indicates that the market does not expect a material decline in bond rates in the near-to-medium term. Indeed, it is difficult to view the recent surge in bond financings in any other light.

Moreover, since bond rates usually reflect the market's inflation expectations, the market seems currently to be registering pessimism. And these pessimistic inflation expectations could indicate strong skepticism concerning government economic policies.

This market skepticism is, to some extent, being hedged, however. A substantial proportion of the bond issues (approximately 60%) since the first of the year have had medium rather than long-term maturities. To be sure, the dominance of medium-term issues in part reflects a restricted availability of long-term funds. But it may also be a sign of some optimism by issuers about an eventual improvement of inflation.

Nevertheless, on balance, a bearish atmosphere is likely to dominate the bond markets for some time. Uncertainty over congressional response to the administration's fiscal proposals is only one part of the problem. Even if enacted, the ultimate effect of the proposals is still regarded by the market as highly uncertain.

A Brief Respite for the Auto Industry

The surprisingly warm response of new-car buyers to the end-of-winter sales rebate programs provided what is likely to be a temporary—but much needed—boost to the beleaguered American auto industry. The rebate program helped trim inventories by 86,000 units in February, reducing stocks 17% below their year-ago level. Despite a sizable gain in production, inventories were undoubtedly cut further in March as sales soared. But when the rebates end, even this lower level of stocks may leave automakers uneasy if sales plunge again. Industry planners are well aware that the current sales rally may well prove to be at the expense of future sales, and they are planning production schedules accordingly.

There is little in the sales outlook for the balance of the year to suggest much improvement over 1980, which was the worst year for the U.S. auto industry in nearly two decades. Domestic car sales for calendar 1981 are expected to total some 9.2 million units, only about 2% higher than last year. Nearly 190,000 auto workers were still on indefinite layoff in February, and production costs are soaring because of the massive retooling and redesign effort undertaken by the auto companies.

The uncertain element in this year's auto forecast, of course, is imports. In the face of bleak sales projections, protectionists have argued that the auto industry is in dire straits. They have lobbied strongly for measures that would hold Japanese-built cars imported into the United States to 1.2 million units per year through 1985. This would be some 33% lower than the 1.8 million sold here last year when the Japanese captured a record 26.7% of the U.S. market. Instead of requesting any formal measures to restrain Japanese imports, however, President Reagan has opted for a much more informal approach, suggesting to the Japanese that they take it upon themselves to curb auto shipments to this country in the interest of preserving sound trade relations. The administration also plans to announce shortly a package of tax and regulatory changes designed to provide some cost relief to domestic auto producers.

The onslaught of foreign cars, for all the suffering it has caused in the U.S. industry, has served to focus attention on the changed structure of the auto industry around the world that has resulted from the shift in consumer preferences toward smaller, more fuel-efficient vehicles. Auto markets are no longer segmented by regional and national boundaries. The policy approach adopted by President Reagan will provide only minimal soothing of the auto industry's current pain. But the refusal to erect new trade barriers, coupled with a reduction of the crushing regulatory burden on auto manufacturers will do much more over the longer term toward bringing the industry back to health.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				central bank rate	exchange rate in U.S. dollars		
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	March 25, 1981	March 25, 1981	current monetary conditions	
Austria	Zero growth or a small GDP decline expected for 1981, after 1980 real growth of some 3.5%.	Oct.	+ 3%	67.9	+ 4.6%	Jan.	4,940	+ 31%	2.4	0	Current-account gap 47 billion schillings in 1980; some narrowing seen for 1981.	Jan.	+ 7%	Nov.	+ 9%	6.75%	.0678	Credit moderately restrictive.	**Austria**
Belgium	Leading indicators continue to point down as German recession is felt; incomes policy in place.	Dec.	− 16%	118.9°	+ 2.1%°	Jan.	7,787	42%	1.4	0	Current-account gap over $6 billion in 1980; further widening likely in 1981.	Feb.	+ 7%	Sept.	+ 1%	12.00%	.02924	Interest rates raised in wake of renewed franc weakening.	**Belgium**
Britain	Output continues to decline as the government introduces third successive deflationary budget.	Jan.	− 12%	403.1	+ 0.9%	Jan.	20,903	+ 2%	2.1	622	Payments balance for first two months of 1981 in surplus by over $4 billion.	Feb.	+ 13%	Dec.	+ 6%	12.00%	2.2635	New money growth target range represents policy easing.	**Britain**
Denmark	Industrial production currently more than 10% below year-ago level.	Nov.	− 4%	65.0	+ 3.5%	Jan.	3,288	+ 19%	2.1	0	January trade gap narrowed to kr. 1.02 billion, vs. kr. 2.23-bn. gap in Jan. 1980.	Dec.	+ 11%	Oct.	+ 5%	11.00%	.1522	Money supply growth rate in 1980 was 10.9%.	**Denmark**
Finland	Economy continues to grow at a healthy pace.	Nov.	+ 3%	40.4	+ 7.2%	Jan.	1,624	− 7%	1.2	83	Payments deficit reached 5 billion markkaa last year, vs. 0.8 billion in 1979.	Jan.	+ 13%	Sept.	+ 9%	9.25%	.2481	Monetary policy remains tight.	**Finland**
France	Presidential elections unlikely to provide major impetus to business.	Jan.	− 8%	475.2	+ 3.2%	Dec.	27,340	+ 56%	2.5	0	Reduced import demand may narrow 1981 current-account deficit.	Feb.	+ 13%	Nov.	+ 11%	9.50%	.2030	Money tight in short run; franc weakness likely by yearend.	**France**
Germany	Foreign orders surge, but other main indicators continue to fail; real GNP decline expected in 1981.	Jan.	− 5%	766.8	+ 4.5%	Jan.	46,569	− 10%	3.0	0	Decline in mark versus dollar boosting oil bill in mark terms.	Feb.	+ 6%	Jan.	+ 6%	7.50%	.4793	Fall in U.S. rates permits easing of rates from Feb. highs.	**Germany**
Ireland	Slow pace of economic growth expected during 1981.	Sept.	− 10%	14.7	+ 1.9%	Jan.	2,687	+ 21%	3.0	0	Exports holding up despite cost rises and slow growth abroad.	Nov.	+ 18%	Nov.	+ 16%	12.75%	1.7475	Large budget gap forces tight controls on private credit.	**Ireland**
Italy	Economic downturn continues; inflation still exceeding 20%.	Jan.	− 6%	324.2	+ 5.0%	Jan.	22,089	+ 12%	2.6	0	Current-account gap estimated at $10 billion in 1980.	Feb.	+ 20%	Nov.	+ 14%	19.00%	.000962	Credit tightened; small-denomination loan growth limited.	**Italy**
Netherlands	Industrial production sustains decline as recession intensifies.	Dec.	− 2%	148.8	+ 2.3%	Jan.	11,211	+ 32%	1.7	0	Trade gap smaller than feared as high gas prices boost export receipts.	Feb.	+ 7%	Nov.	+ 4%	9.00%	.4323	Interest rates ease somewhat—in line with Germany.	**Netherlands**
Norway	Most industries facing problems, but booming oil sector will allow steady output growth in 1981.	Nov.	0	44.5	+ 3.2%	Jan.	5,322	+ 26%	3.8	0	Another large trade surplus in February; healthy balance likely for all of 1981.	Jan.	+ 15%	Nov.	+ 12%	9.00%	.1863	Tight money policy sustained, owing to high inflation.	**Norway**
Portugal	Investment buoyant, but drought will affect 1981 agricultural output.	June	+ 7%	19.7	+ 3.2%	Dec.	795	− 15%	1.1	108	Exports weak in IV Q 1980; $1 billion current-account gap last year.	Nov.	+ 12%	July	+ 26%	18.00%	.0178	Financial system highly liquid.	**Portugal**
Spain	Domestic and external demand remain depressed.	June '79	− 3%	195.9	+ 1.5%	Nov.	11,969	− 11%	4.3	256	Current-account shortfall of $4.8 billion in 1980; worsening likely in 1981.	Dec.	+ 15%	Nov.	+ 14%	8.00%	.0011795	M3 growth reduced to 16% in December.	**Spain**
Sweden	Economics Ministry now predicts real GDP growth of some 0.4% in 1981.	Nov.	− 2%	100.6	+ 3.7%	Jan.	2,993	− 14%	1.1	0	Current-account gap of 12.3 billion kronor in 1980; little change expected in 1981.	Dec.	+ 14%	Dec. '79	+ 16%	12.00%	.2188	Some monetary easing now possible after January tightening.	**Sweden**
Switzerland	Latest industrial orders reflect continued economic strength; overseas demand likely to weaken.	Dec.	+ 1%	99.0	+ 0.7%	Jan.	12,400	− 7%	4.4	0	Export order books remain healthy.	Feb.	+ 6%	Nov.	− 6%	4.00%	.5249	Monetary conditions to stay tight for mark/franc stability.	**Switzerland**
Turkey	Domestic recession continues; new credits sought to finance import bill.	n.a.	n.a.	69.3	+ 1.7%	Sept.	1,190	+ 15%	2.2	1,028	Exports and worker remittances rose sharply in November-December.	Sept.	+ 101%	Nov. '79	+ 11%	—	n.a.	Credit continues highly restrictive.	**Turkey**
Canada	Current manufacturing problems attributed to shortages of capital and skilled labor.	Jan.	− 1%	222.3	+ 2.7%	Jan.	2,523	− 17%	0.5	0	Current-account gap of $1.5 billion in 1980 was lowest since 1974.	Feb.	+ 12%	Jan.	+ 7%	16.59%	.8468	Credit demand strong in face of high interest rates.	**Canada**
United States	Renewed weakness in housing and auto sectors presages GNP decline.	Feb.	− 1%	2,413.9	+ 3.2%	Jan.	17,157	+ 75%	0.8	0	Current-account surplus of $118 million in 1980 likely to be revised up.	Feb.	+ 11%	Feb.	+ 7%	13.00%	—	Market rates drop as short-term credit demands weaken.	**United States**

° 1980 ° 1979

World Interest Rates

market rates of Mar. 25, 1981; bond yields as of Mar. 20, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty large banks 16.00	16.59	12.00*	12.00	9.50*	7.50*	19.00	9.00*	4.00*	6.25
Day-to-Day Money	14.375 Mar. 26	18.00	13.00*	13.00	11.625*	11.00*	17.50*	9.00*	7.625*	7.875
Treasury Bills 91-day, Middle Rates	12.76	16.35	11.75*	13.75	13.46* one year	n. a.	15.501* 70 day	no dealing	no market	5.875 two month
Commercial Paper prime, 3-month, asked	12.25 finance paper	16.90 finance paper 15% tax w/h	11.36*	11.50 Certified	12.375* Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.35	16.70 15% tax w/h	11.75*	11.80 Certified	not traded	9.90*	20.05*	no market	4.50*	no market
Government Bonds Long-term, new and old issues, average yield	12.65	13.97	13.03	11.55 20% tax w/h	14.30*	9.70	16.76*	11.42*	5.43*	8.01
Industrial Bonds prime, long-term, new and old issues, average yield	13.30 Aa Industrials	14.50	14.18	16.27	15.45*	9.65	17.46*	12.15*	6.23*	7.05
Bank Short-Term Rate to Best Borrowers (prime rate)	17.50	17.75	13.00*	15.50	14.35*	12.00*	21.00* ⅛ quar'ly fee on outstdng.	12.50*	6.00*	7.50
Bank Time Deposits 3-month	13.50 Cert. of Dep	16.00	12.50*	13.50	12.5625*	13.15*	10.75*	10.50* large deposits	8.3125* residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	14.75	no market	12.75	no market	12.50	12.5625	no market	10.25	7.9375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8468	2.2635	.02924	.2030	.4793	.000962	.4323	.5249	.004791
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.00 *D*	1.875 *P*	0.50 *D*	2.00 *P*	2.50 *P*	6.50 *D*	4.25 *P*	6.75 *P*	6.125 *P*

Eurodollar Deposits
(London, interbank, bid)
March 26

7-day	**14.0625**
1-month	**14.4375**
3-month	**14.875**
6-month	**15.0625**

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	**−0.84***
U.S.-Canada Treasury Bills	**−0.73**
U.S.-Canada Finance Co. Paper	**−2.42**
Eurodollars-U.K. Local Auth. Deposits	**+0.02***

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	**14.25**
Over 7 yrs.	**14.75**
DM Bonds	
7 yrs. and under	**10.125**
Over 7 yrs.	**9.90**

Gold Price
London
afternoon fixing

528.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of March 18; bond yields as of March 13.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	11.3 (Feb.)	12.2 (Feb.)	12.5 (Feb.)	12.7 (Feb.)	5.5 (Feb.)	19.5 (Feb.)	6.0 (Feb.)	7.4 (Jan.)
Industrial production*	−1.2 (Feb.)	−0.5 (Jan.)	−11.9 (Jan.)	−8.1 (Jan.)	4.8 (Jan.)	6.4 (Jan.)	1.0 (Dec.)	3.5 (Jan.)
Trade balance† *(billions of local currency units)*	−$5.44 (Jan.)	C$0.68 (Jan.)	£0.31 (Feb.)	−FF3.90 (Feb.)	−DM0.92 (Jan.)	−Lit.1,500 (Jan.)	−SF0.78 (Feb.)	¥303 (Feb.)
Money supply (M1)*	6.6 (Feb.)	6.7 (Jan.)	5.9 (Dec.)	11.1 (Nov.)	5.8 (Jan.)	13.7 (Nov.)	5.7 (Nov.)	1.8 (Dec.)
Velocity of money (M1)*	4.6 (Dec.)	5.6 (Sept.)	8.7 (June)	n. a.	3.0 (Sept.)	6.6 (Sept.)	n. a.	12.5 (Sept.)
Reserves minus gold *($ million, change from previous month)*	1.560 (Jan.)	−570 (Jan.)	247 (Jan.)	−1.240 (Dec.)	689 (Jan.)	−1,051 (Jan.)	−3.256 (Jan.)	1.285 (Jan.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated

U.S. Policy in Transition

The following is based on remarks given by **Willard C. Butcher,** *President and Chief Executive Officer of The Chase Manhattan Bank, N.A., before the American Chamber of Commerce in Paris, France on March 12, 1981. Mr. Butcher formally assumes the chairmanship of Chase at the end of April when David Rockefeller steps down.*

President Ronald Reagan took office in January, but the significance of his presidency has become increasingly apparent since the announcement of his economic program last month. Mr. Reagan has proposed substantial spending and tax cuts. Taxes would be slashed $54 billion in the first year of his program. Over a three-year period, individuals would receive tax cuts that would total an average of 30%. Government spending would decline about $45 billion in year one.

What is more important than the specific numbers, however, is the significant change in direction that the President has taken. We are seeing the first serious program in almost half a century to alter the economic course of the United States. And it has arrived not one moment too soon.

Government growth has been out of control for more than a decade, and President Reagan aims to bring it back under control. But as important as the President's program is—it is but the first step on a long road to economic rehabilitation. I expect the new administration to refortify other fundamentals including defense, energy, and trade policy.

There are those who might express some disappointment that the Reagan economic package's proposed cuts are not large enough. And laid against the context of massive government growth in the United States, there may be some merit to that argument. After all, the government's insatiable appetite for our money is well documented by the rapid rise in taxes as a percentage of national income. Through deficit spending and the inflation it spurs, government has been swallowing a growing share of private savings too.

Clearly, an argument can be made for major surgery on the U.S. budget. The cuts President Reagan has announced thus far may appear small, but the change of policy direction they represent is historic.

The spending cuts also are equitable. More than a few oxen are being gored—including one or two of my own favorite programs. Spending cuts have to be big enough to be credible, but not so big that they could never get through Congress. In this context, I think President Reagan learned something about spending cuts from the previous administration. President Carter proposed cuts that were too small to have a significant impact on government spending. Since the overall package was not meaningful, no legislator was willing to sacrifice his favorite spending program for a package that was largely symbolic. So what began as a very modest spending-cut proposal was whittled down to next to nothing.

On the other side of the ledger are the President's proposed tax cuts, which recognize that productivity gains depend on lower taxes for business and individuals.

As Governor of California, Mr. Reagan enjoyed considerable success steering his programs through a legislature controlled by the opposition party. This experience should serve him well over the next several months. And so will the mandate he has been given by the American people.

Indeed, I believe the Reagan victory and the continued support of his economic package herald a major—and I hope, lasting—shift in American popular opinion. Years of negligible growth and persistent inflation have caused Americans to question the statist principles that were a virtual orthodoxy over the past two decades. I therefore believe that recalcitrant liberal legislators—remembering the fate of their colleagues in the last election—will think twice before obstructing a spending and tax-cut program that has broad public support.

As you might suspect, most American businesspeople are heartened by recent trends in the United States. I know I am. On a broader scale, I sense that what is happening in the United States reflects a growing trend in wider parts of the world as well. The concern for sound economic and political fundamentals is growing. The past elections in Great Britain and Jamaica are examples, and so is the ongoing concern for stable economic growth and productivity displayed in France, West Germany, and Japan.

Governments everywhere in recent decades extended their reach into areas that had been the purview of private citizens. Moreover, as governments have assumed added powers, they have tended to neglect what British historian Paul Johnson has called the "three essential activities" of any government: to maintain *first*, external security, *second*, internal tranquility, and *third*, a sound national currency. In recent times, government has grabbed for extra powers outside its traditional realm, and it has capitulated in those three key areas for which it is primarily responsible.

Fortunately, there seems to be a renewed concern

U.S. Policy in Transition

(continued from page 7)

for the fundamental well-being of the state. This should have a far-reaching impact that will go well beyond domestic economic policy. By addressing these "fundamentals," I expect to see in America such things as a stronger defense posture, a more forceful energy policy to reduce our dangerous dependence on OPEC oil, and renewed concern for *fair*—as well as *free*—trade.

Without question, there is renewed concern in Washington for defense. Military spending, long neglected, is budgeted to increase. What is more important, foreign policy will be more consistent and purposeful under the new administration. I expect President Reagan to take a pragmatic approach to international affairs. His first concern, as is should be, is what is best for America. But he is mindful of the essential interdependence of our world and the importance to the United States of vigorous allies. Although U.S. concern for individual rights and personal freedom will not diminish, I expect U.S. policy to be more consistent with our overall strategic concerns.

One fundamental strategic concern that the United States shares with France and other industrialized nations, is the need to develop and maintain reliable energy sources. We simply must reduce our dependence on Mideast oil. The OPEC oil surplus this year again is likely to exceed $100 billion. Despite all the talk of recycling, such a huge OPEC surplus represents a transfer of wealth that comes directly out of the pockets of each one of us.

The initial effects of the oil price increases of 1979-80 have been less severe on the world economy than the increases of 1973-74. But over the longer term, these oil price shocks may prove even more debilitating. And the surplus may remain high for a sustained period, raising questions about the ability of weaker economies to finance payments deficits.

Our dependence on Mideast oil—as the war between Iran and Iraq has graphically underscored—makes us increasingly more vulnerable. The free world must therefore act with unity in devoting increased resources to energy self-sufficiency. Although the record of the United States has improved, we remain laggards in the effort to free ourselves from high oil imports. We cannot hope to eliminate totally our dependence on oil imports, but we can reduce this dependence to more manageable proportions.

President Reagan has chosen wisely to deregulate the price of domestically produced oil. This should be an important contributor to production and conservation. However, we must have a multi-faceted attack that also would include greater use of such resources as coal and nuclear power.

Finally, I also expect a new pragmatism in the United States with respect to trade policy. The American automobile, steel, and other industries have been assaulted by foreign competition. We hear frequent calls to batten down the hatches against imports and shield our workers from foreign competition.

To succumb to protectionist pressure, however, would be disastrous to the entire world economy including, ultimately, the United States itself. Yet it is difficult to fight such protectionist sentiment in the United States when there is an apparent unwillingness on the part of some trading partners to open up their markets, or to eliminate the strictures they place against foreign business.

Our global economy remains replete with deterrents to free—and more specifically, *fair*—trade. These deterrents—such practices as import dumping and tariff and nontariff barriers to exports—can be found in every trading nation. I am certain, for example, that it would not be difficult for foreign observers of the U.S. economy to document examples of U.S. policies that stifle imports.

Over the years, we have achieved much progress in opening up the channels of trade through successive rounds of the General Agreement on Tariffs and Trade (GATT) negotiations. But I fear that we have reached a point of diminishing returns when it comes to addressing the elusive yet persistent nontariff barriers that stifle exporters in many nations.

While I do not in any way wish to curtail multilateral conversation, I do think there is mounting interest in supplementing these negotiations with more meaningful and equitable bilateral agreements between nations. I believe fair trade depends on three principles: no dumping of subsidized or surplus goods; sensitivity to the well-being of essential domestic industries; and reciprocity. I believe these three concerns can be addressed most effectively in a bilateral context. If we do not have meaningful and even-handed trade policies, I fear the hue and cry for protectionism in the United States and around the world will mount. The consequence of inequitable trade policies is always less trade. The greatest assurance of free trade is fair trade.

America's renewed commitment to buttressing its economic and political fundamentals obviously entails some practical, hard-headed self-interest. This does not mean that we are turning our backs on our allies or the world in general, however. We cannot escape the fact that the world is moving closer together or, put another way, is becoming increasingly "globalized". Our prosperity depends on world trade and our survival depends on world peace.

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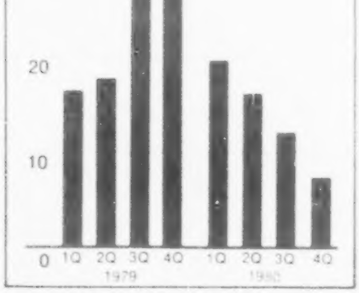
U.S. Export Growth Declines

Although U.S. exports in 1980 were up a substantial 21% from 1979, a look at seasonally adjusted quarterly data indicates that the pace of this growth declined steadily over the course of the year. The slowdown is partly related to the deteriorating competitive position of U.S. exporters—for example, since the fourth quarter of 1979 the average price of German exports in terms of dollars has fallen more than 20% relative to U.S. export prices—but the most important reason for the decline has been the worsened economic performance of the United States' major trading partners, particularly in Europe.

During the period of very strong growth of U.S. exports—first-quarter 1978 to second-quarter 1980—most of the European economies were growing rapidly. In that period, U.S. exports to Europe increased at an annual average rate of more than 40%, and the U.S. share of total exports from the industrialized countries climbed from 16.9% to 18.1%, a significant advance. Since the second quarter of last year, however, U.S. exports to Europe have plummeted, with fourth-quarter 1980 figures some 11% below the second-quarter 1980 level. The falloff in U.S. exports to Europe coincided with the slump in European economic activity beginning in the second quarter of last year. After a strong performance in the first quarter of 1980, the European economy moved abruptly into a recession that now appears likely to exceed in magnitude the downturn of 1974-75, which followed the first OPEC price shock. Real output of the European Economic Community economies in the last quarter of 1980 was down an estimated 2.5% from first-quarter-1980 levels, and the outlook for the first half of 1981 is for further decline.

In these circumstances, even though exports to the rest of the world have held up reasonably well, the rate of expansion of total U.S. exports since mid-1980 has fallen sharply from the levels of the early-1978 to mid-1980 boom period—to about 8%-9% on a seasonally adjusted annual-rate basis. Even so, given the generalized slowdown in world trade, this growth has been sufficient to keep the U.S. share of exports from the industrialized countries relatively stable. Given the current outlook for the performance of the world economy, it seems likely that U.S. exports will grow at about their present subdued pace at least until summer, with some acceleration likely later in the year as inventories are rebuilt abroad. The key uncertainty remains the timing of economic recovery in Europe, and not the strength of the dollar.

U.S. export growth*
(growth over preceding quarter, seasonally adjusted annual rate)



* Census basis (f.a.s.)

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Belgian industry bears brunt of adjustment to higher oil prices.

The burden of Belgium's adjustment to higher oil prices and the concomitant effect on real national income has been in part borne by industry and partly postponed through running a current-account deficit. Real wages, on the other hand, have been protected in recent years through indexation. The squeeze on industry has thus resulted in declining profits, investment, and employment. Depressed economic activity and a large current-account deficit have led to urgent calls for a devaluation to improve industry's competitive position. But the authorities have argued that any gain in competitiveness would be short-lived as resulting price rises quickly feed through to wage rates. The preferred course of official policy is to shift some of the adjustment to the personal sector through freezing or limiting index-linked wage increases. Meanwhile, economic and political uncertainty has led to intense speculative pressure on the Belgian franc. To date, the authorities have sought to protect the franc through restrictive fiscal and monetary policy, as evidenced by the National Bank's recent heavy intervention in the exchange markets and by a three-percentage-point boost in the discount rate to 16%.

Spain making progress toward liberalized financial system.

Spain has taken a second, albeit hesitant, step on the path toward liberalizing its domestic financial system. The restrictive regulations covering interest rates have been lifted on rates for deposits over six months and on all loans. Also, banks have been freed of dividend controls. Savings banks now face the same regulations as commercial banks, and clear-cut rules have been established regarding commissions. However, the system of required low-interest investments—"privileged circuits"—remains, and until this is removed Spanish financial markets cannot be considered fully liberalized. Otherwise, there is little to be optimistic about on the Spanish economic scene. This year's drought will inhibit agricultural production, and recent political developments have weakened business confidence. In the face of a continuing balance-of-payments deficit, the peseta has slipped in line with the German mark. Although this will make Spanish exports more competitive, it will heighten inflationary pressures.

Persistent Icelandic inflation continues to cause problems for the kronur.

Continued inflation has so eroded the value of the Icelandic currency that in January of this year the government introduced a new kronur with a value equal to 100 old kronur. Inflation continues to run at an annual rate of around 50%. And despite the imposition of a price freeze and an attempt to reduce the extent of wage indexation, the price level in December 1981 is expected to be some 40% above where it stood at the end of 1980. This has forced the authorities to depreciate the kronur on the foreign exchanges. The most recent decline was announced in mid-February, when the kronur was devalued by 3.7%. The recent strength of the U.S. dollar has also caused some problems for the authorities, and the central bank has now reverted to controlling the kronur against a basket of currencies instead of solely against the dollar. Aside from its inflation problems, the Icelandic economy appears reasonably healthy. The fishing industry is still experiencing strong export demand, and in contrast with many other OECD members, Iceland's GDP is still expected to grow this year.

Argentine peso devalued to spur domestic and external economy.

The 22.7% devaluation of the Argentine peso on April 3 is part of a set of new economic measures instituted by the incoming administration of President Viola. The purpose of the latest package is to spur exports and domestic production, which had been declining prior to the announcement of the devaluation. Previously, the Argentine currency had been under considerable market pressure, and reserves were lost as perceptions spread that the peso was overvalued. Along with the devaluation, the government has indicated that the peso will go on a managed float with monthly devaluations of approximately 2%. To moderate the inflationary impact of the recent and future devaluations, tariffs are being reduced to 43% from 55%, export rebates and taxes are being modified to restrain domestic food costs, and the fiscal deficit is being limited.

Brazilian trade position improves.

Brazil's foreign trade deficit for the January-February period totaled $260 million, as against $891 million for the year-earlier period. Annualized, the deficit for 1981 would total $1.5 billion, well below the $2.8-billion deficit for all of 1980. The reasons for the improved trade showing in 1981 are strong exports and slackening non-oil imports. Coffee export receipts for January-February 1981 were more than double their level in 1980, and other export earnings were up 22%. The oil import bill was larger because of price rises, but non-oil imports were down by more than $200 million. A softening economy and the drawdown of primary goods inventories have been major causes of the fall-off in non-oil imports. If these favorable trends are sustained throughout 1981, Brazil could meet its target of a trade balance ranging between plus or minus $1 billion.

Broad-based industrial expansion bolsters Jordanian economy.

Jordan completed the final year of its 1976-80 five-year plan with a sound economy and is now set to commence a soon-to-be announced 1981-85 plan. Economic performance in 1980 was led by an exceptional industrial production growth rate of 44%. Much of this was due to an increase in phosphate production to 3.9 million tons from 2.8 million tons in 1979. In addition, there was a broad-based expansion in manufacturing output in response to buoyant demand from both Iraqi and domestic sources. Progress was also achieved in the financial sector. Inflation was reduced to 11.1% from 14.2%, and the average growth of the money supply (M2) was cut to 23.6% from 29.7% in 1979. Aid grants last year, which remain critical to Jordan's economic health, are estimated to have continued at 1979 levels, at about $1 billion. The new five-year plan is expected to call for a continuation of high growth—more than 10% annually. Industrial expansion is planned to lead economic growth again. A decline in the trade deficit is also envisaged. Furthermore, the government's current deficit is expected to be eliminated by the end of the plan period. On the assumption that regional political divisions do not re-emerge, the plan targets appear attainable.

Bangladesh heavily dependent on foreign aid, but agricultural rebound likely to spur growth.

The dominant influences on the performance of the Bangladesh economy continue to be changes in foreign aid levels and the weather. A shortfall in aid disbursements for fiscal 1981 (ending June 30) led to a sharp drop in reserves in calendar 1980. The three-year IMF loan of 800 million SDRs announced in December resolved the country's balance-of-payments crisis temporarily. However, questions remain concerning how long aid inflows, even coupled with IMF credit, will be sufficient to cover the balance-of-payments funding gap implied by the government's development objectives. Although the balance-of-payments problem has worsened, the domestic economic situation has improved, thanks to favorable growing conditions in the agricultural sector. Foodgrain production in fiscal 1981 is projected at a record 13.8 million tons, and, as a result, real economic growth is expected to rebound to the 7%-9% range. But inflation, now forecast at 12%-13% for the fiscal year, could become increasingly troublesome without tighter constraints on the growth of the government deficit and central bank credit to the government.

Zinc demand expected to show little change in 1981.

The course of zinc prices in 1981 will be affected only slightly if the U.S. Treasury shifts from copper to zinc in the production of the U.S. penny. The production of a zinc penny in the United States would increase total zinc demand by little more than 1% during the first year of production of the new coin; world demand could be boosted further as other countries are also considering switching to zinc coins. Barring a shift to the zinc penny this year, demand is likely to be unchanged from last year, owing to weakness in the construction and automobile industries associated with the worldwide economic slump. Supply, however, is anticipated to grow more than 2% after decreasing by over 5% last year. Inventories are thus expected to expand this year after declining in 1980. Zinc prices in 1981 are likely to average 36¢-40¢ per pound—considerably below average total costs—with or without the introduction of the zinc penny.

A Misdirected Proposal on Money Reporting

The Federal Reserve Board recently announced that it is considering changing its procedures for reporting weekly money supply figures. Prompting the proposal were concerns about both the significance of the weekly money numbers and the financial markets' reaction to them. Federal Reserve Chairman Paul Volcker noted, however, that the Board is uncertain whether any benefits would be derived from the alternative reporting procedures being considered, or if any such benefits would outweigh the costs.

It is well recognized that the weekly seasonally adjusted money supply figures are subject to wide random fluctuations–that is, movements unrelated to changes in trend money growth. Since Federal Reserve policy decisions are affected by movements in the money supply relative to the Fed's targets, unexpected weekly money supply changes often cause sizable movements in interest rates, as financial market participants revise their expectations of future money growth and interest rates. Some observers have suggested that financial markets are prone to "overreact" to these inherently volatile money numbers, thereby causing "unnecessary" fluctuations in interest rates. A number of proponents of this view argue that the weekly money numbers–which are preliminary and subject to revision–contribute to instability in financial markets.

One change the Federal Reserve is considering as a means of reducing this volatility is to delay publication of the money supply numbers an additional seven days to incorporate data not available when the preliminary money numbers are released. The rationale is that revisions to weekly money numbers would be reduced. But this option would have a limited effect on the volatility of the money numbers, as weekly revisions are usually relatively small. Moreover, market participants would still attempt estimates of the weekly money supply using available data. It is not clear, and indeed improbable, that this option would reduce interest-rate volatility.

A second option being considered is publishing only money numbers not adjusted for seasonal forces, to reduce the "importance" of the money numbers. If this option were implemented, however, market participants would construct their own seasonal factors, as well as estimate how the Federal Reserve is adjusting the money supply for seasonal effects. This could heighten market confusion.

Yet another change being considered is publishing the money figures only on a monthly basis, and/or publishing weekly figures only on a moving-average basis. This change would not keep market participants from constructing estimates of weekly money numbers from available data, however. Moreover, providing markets with data only monthly could cause even wider swings in interest rates, with market apprehension and uncertainty becoming quite pronounced just prior to the release of monthly money supply numbers.

Perhaps the most distressing aspect of all of these options is that they involve providing the financial markets with *less* information than is currently available. Already, the Federal Reserve keeps market participants in the dark regarding both the prevailing trading range for the federal funds rate and the growth targets for various bank reserves measures. For example, it was not until early April that the Federal Reserve released the minutes of the *February* Open Market Committee meeting–in which the 15½–20% target range for the federal funds rate in effect in February was announced, and in which no targets for bank reserves were divulged.

It is this *lack* of information regarding the targets for the instruments of Federal Reserve policy, combined with the statements of Federal Reserve officials regarding the importance of the behavior of the money supply in policy formulation, that causes financial markets to be so sensitive to the weekly release of money numbers. Market participants make estimates of what the Fed plans to do and what effect its actions will have on interest rates. Historically, even short-run deviations of money growth from target have had a significant impact on the federal funds rate. In fact, a number of economists have noted that under a nonborrowed reserves targeting strategy–such as the one purportedly in practice since October 6, 1979–unexpected changes in the money supply, whatever the cause, tend to be translated quickly into changes in the federal funds rate.

Thus, it is not the irrational response of financial market participants to weekly money supply numbers that is behind the recent volatility of interest rates. Rather, the current operating strategy of the Federal Reserve, combined with the paucity of information available to the market concerning the Fed's short-run objectives, causes the money numbers to have such large effects on financial markets.

Rather than giving the market less information, perhaps the Federal Reserve should shift gears and provide the market with *more* information. If market participants knew, for instance, what the reserves-supplying objectives of the Federal Reserve were, when (and why) the Fed was allowing the path of reserves to deviate from these objectives; what the target range for the federal funds rate was; what behavior of the money supply (reserves/etc.) would cause the Fed to change its policy stance; and what decisions were reached at monthly Open Market Committee meetings *immediately* after each meeting–then the market response to weekly money numbers would probably be less severe, and would certainly be less prone to "overreaction."

As it stands now, however, the fact that markets at times react violently to weekly money numbers is not an indictment of the method in which money numbers are reported, but–if anything–a reflection on the conduct of monetary policy itself. *Thomas A. Lawler*

Asia and Oceania

Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
			6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes latest data	12-month changes consumer prices	12-month changes latest data	12-month changes money supply(M1)	exchange rate in U.S. dollars April 8, 1981	change from year earlier April 8, 1981	current monetary conditions	
Asia	Bangladesh	Real GDP growth of 7%-9% possible in fiscal 1981, owing to rebound in agriculture.	Oct.	+ 2%	13.7	$ 160	Feb.	316	− 30%	1.4	310	Slower-than-expected shift to domestic natural gas keeps oil imports high.	Dec.	+13%	Oct.	+17%	.0650	− 2%	Tighter monetary policy likely under IMF program.	Bangladesh
	Burma	Real GDP rising at 6% rate, owing mainly to progress on agricultural front.	Dec.	+ 16%	5.0	154	Feb.	262	+ 11%	11.5	33	External debt and debt service rise rapidly.	Oct.	− 3%	Sept.'79	+ 14%	.1500	− 1%	Free-market premium on kyat declines.	Burma
	China, People's Republic	Revised 1981 budget cuts investment more than 40% with cancellation of major projects.	Dec.	+ 20%	517.0	510	Sept.	3,615	+ 13%	2.7	456	Trade deficit in 1980 reduced to only $500 million.	n.a.	—	—	—	.6100	− 10%	Money supply growth restricted to control inflation.	China, People's Republic
	Hong Kong	Boom cooling as real estate and stock market prices decline.	Nov.	+ 26%	17.6	3,320	n.a.	—	—	—	—	Exports decline moderately in reaction to recession in OECD markets.	Nov.	+ 15%	Nov.	+ 22%	.1880	− 6%	Interest rates expected to follow U.S. rates down.	Hong Kong
	India	Fiscal 1981/82 budget cuts taxes and provides new incentives for investment.	Nov.	− 11%	125.3	194	Nov.	7,215	− 3%	6.6	325	Customs duties increased to raise revenue and discourage imports.	Dec.	+ 9%	July	+ 2%	.1215	− 4%	Interest rates raised to promote savings.	India
	Indonesia	Many local industries benefit from oil and gas boom.	May	+ 61%	47.1	317	Jan.	5,993	+127%	7.9	0	Non-oil exports soften in response to recession in major markets.	Jan.	+ 17%	Oct.	+ 49%	.00160	0	Central bank maintains lid on bank credit.	Indonesia
	Japan	Consumer spending and residential construction continue weak, but investment stays firm.	Jan.	+ 32%	1,011.1	8,726	Feb.	26,170	+ 31%	2.2	0	New products and markets blunt impact of OECD recession and protectionism.	Feb.	+ 7%	Jan.	− 2%	.00468	+ 18%	Monetary policy relaxed to spur economic activity.	Japan
	Korea	Difficulties encountered in auto merger; rationalization plan for other industries in doubt.	Nov.	+ 15%	60.1	1,598	Feb.	2,771	+ 1%	1.5	828	Revival of exports slowed by U.S. and European recessions.	Jan.	+ 32%	Jan.	+ 16%	.00151	− 11%	Won depreciation less than 3% in last six months.	Korea
	Malaysia	Business profits increase; government presses efforts to expand Malay share of equity.	Oct.	+ 12%	19.4	1,457	Dec.	4,387	+ 12%	4.8	0	Trade balance favorable; interest-rate differential causes outflow of capital.	Dec.	+ 7%	Dec.	+ 15%	.4343	− 1%	Domestic liquidity reduced by outflow of funds.	Malaysia
	Pakistan	IMF program improves climate for private-sector activity.	Nov.	+ 11%	23.0	288	Feb.	641	− 14%	1.4	330	Foreign direct investment spurred by export processing zones.	Dec.	+ 16%	Dec.	+ 18%	.1020	− 1%	Restrictive monetary policy likely under IMF program.	Pakistan
	Philippines	Low copra export prices and higher petroleum import product prices depress business activity.	Oct.	+ 20%	29.9	627	Feb.	2,506	+ 9%	3.4	814	Current-account deficit will increase in 1981 unless commodity prices recover.	Jan.	+ 14%	Dec.	+ 20%	.1335	0	Central bank prepares to lift most interest-rate ceilings.	Philippines
	Singapore	Led by financial sector, oil services, and shipbuilding, economy sustains rapid growth.	Dec.	+ 25%	8.9	3,790	Nov.	6,523	+ 15%	3.1	0	Current-account deficit widens as oil bill climbs.	Jan.	+ 6%	Nov.	+ 11%	.4765	+ 7%	Government reorganizes Monetary Authority.	Singapore
	Sri Lanka	Government expenditure slashed further in attempt to control budget deficit.	Nov.	+ 3%	3.3	226	Feb.	220	− 53%	1.3	257	Trade deficit could exceed $1 billion in 1981.	Nov.	+ 24%	Nov.	+ 24%	.0575	− 8%	Greater control over budget will reduce money supply growth.	Sri Lanka
	Taiwan	Textiles, garments, other export industries suffer declining sales in recession-affected markets.	Nov.	+ 19%	32.2	1,716	n.a.	—	—	—	—	Trade account will show substantial deficit in 1981.	Dec.	+ 22%	Nov.	+ 23%	.0290	0	Thirteen new foreign bank branches spur competition.	Taiwan
	Thailand	Investors shaken by early April coup attempt, but normal activity has resumed.	Dec.	− 12%	27.3	591	Feb.	1,449	− 23%	1.8	154	Balance of payments adversely affected by government energy policies.	Dec.	+ 16%	Oct.	+ 14%	.0505	− 3%	Baht exchange rate firm despite political troubles.	Thailand
Oceania	Australia	Strong capital and consumer spending buoy economy.	Dec.	+ 10%	119.1	8,260	Feb.	2,016	+ 9%	1.0	76	Strong capital inflow more than offsets widening current-account deficit.	Dec.	+ 9%	Dec.	+ 17%	1.1575	+ 6%	Slower money growth favors lower inflation, interest rates.	Australia
	New Zealand	Taxes cut to offset fiscal drag and to stimulate weak consumer spending.	Dec.	+ 16%	20.9	6,730	Feb.	408	− 20%	0.9	147	Recovery in import volume and slower export growth expected in 1981.	Dec.	+ 16%	Jan.	+ 10%	.9100	− 4%	Monetary policy continues restrictive.	New Zealand
	Papua New Guinea	Government projects real GDP growth of 2% each year until 1985.	July	+ 14%	2.3	740	Feb.	395	− 24%	4.5	6	Price trends continue unfavorable for major exports.	Sept.	+ 12%	Jan.	+ 2%	1.5150	+ 7%	Exchange-rate revaluation policy increasingly criticized.	Papua New Guinea

World Interest Rates

market rates of Apr. 8, 1981; bond yields as of Apr. 3, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty-large banks 16.00	16.74	12.00	16.00	9.50	7.50	19.00 penalty rate 22.00	9.00	4.00	6.25
Day-to-Day Money	15.00 Apr. 9	18.25	13.00*	18.00	12.25	12.00	19.75	10.00	3.50†	7.375
Treasury Bills 91-day, Middle Rates	13.67	16.70	11.75*	17.25	13.85 one year	n. a.	17.047 90-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	13.50 finance paper	17.05 finance paper 15% tax w/h	11.46*	15.90 Certified	13.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.85	17.05 15% tax w/h	11.75*	15.90 Certified	not traded	9.90	22.80	no market	4.50†	no market
Government Bonds Long-term, new and old issues, average yield	13.19	14.375	13.12	10.83 20% tax w/h	14.20	9.96	18.06	11.15	5.47†	7.752
Industrial Bonds prime, long-term, new and old issues, average yield	13.70 Aa Industrials	15.00	14.31	18.42	15.37	10.17	18.54	11.89	6.2375†	7.05
Bank Short-Term Rate to Best Borrowers (prime rate)	17.00	17.75	13.00	19.25	14.35	13.75	22.50 ⅛ quar'ly fee on outstdng	12.00	7.00†	6.75
Bank Time Deposits 3-month	14.25 Cert. of Dep	16.80	12.50*	17.25	13.375	13.25	10.75	10.625 large deposits	7.625† residents only	5.00 20% tax w/h
Eurocurrencies 3-month, asked	15.5625	no market	12.25	no market	13.8125	12.0625	no market	10.50	8.3125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8428	2.1880	.02867	.1986	.4672	.000940	.4226	.5123	.004678
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.625 *D*	3.375 *P*	5.125 *D*	1.75 *P*	3.00 *P*	4.375 *D*	2.50 *P*	6.625 *P*	7.50 *P*

Eurodollar Deposits

(London, interbank, bid)
April 8

7-day	12.75
1-month	14.4375
3-month	15.3125
6-month	15.125

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	n. a.
U.S.-Canada Treasury Bills	+.471
U.S.-Canada Finance Co. Paper	−.691
Eurodollars-U.K. Local Auth. Deposits	n. a.

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.50
Over 7 yrs.	14.25
DM Bonds	
7 yrs. and under	10.25
Over 7 yrs.	10.125

Gold Price

London
afternoon fixing

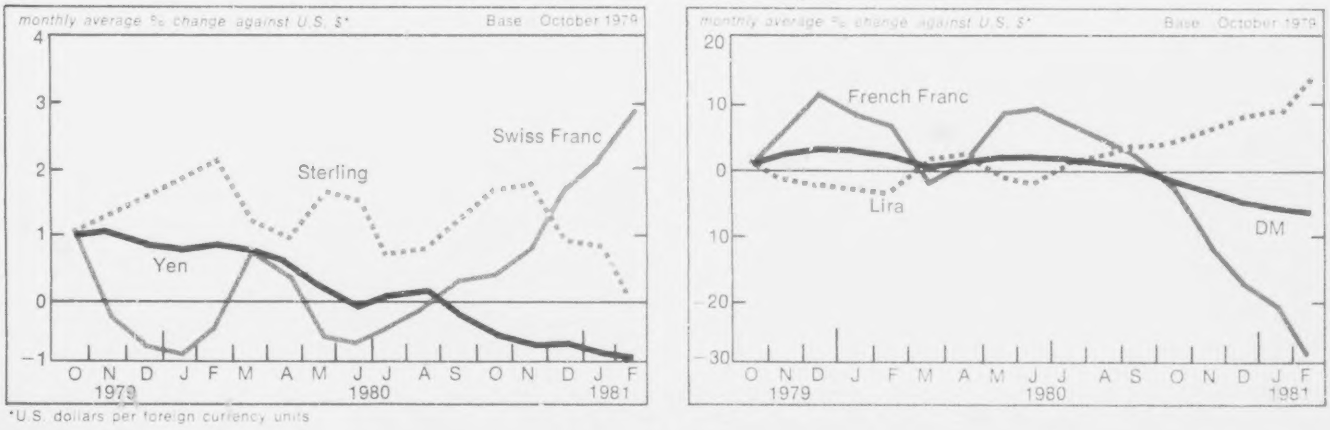
508.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of March 25; bond yields as of March 20.

† Market rates as of April 1; bond yields as of March 27.

Movements of major currencies against the dollar



*U.S. dollars per foreign currency units

Tunisian Economy on Right Track

Tunisia's economic growth rate has been impressive in recent years, averaging about 7%, on an inflation-adjusted basis, between 1977 and 1980. The economy's strengths have included high investment, fiscal moderation, improving terms of trade—particularly for exports of crude oil—access to substantial foreign aid, good external debt management, and relative socio-political stability. These have left Tunisia with plentiful reserves of foreign exchange, manageable current-account deficits and a low external debt service ratio.

The North African country, however, remains vulnerable in some areas. Tunisian agricultural production is still highly dependent on the capriciousness of the weather, and this, coupled with a rapid population growth rate, points to the continued need for large food imports and periodic shortfalls of agricultural exports. Moreover, in the absence of new discoveries of large oil fields, declining crude oil production combined with rapidly rising domestic consumption and imports could make Tunisia a *net* oil importer as early as 1985. Furthermore, the growth of remittances from workers located abroad is slowing as a large number of Tunisians return from Europe and Libya. And restrictions on imports by an enlarged European Economic Community could limit the expansion of Tunisia's agricultural commodities and manufactures.

Recent economic performance

The domestic economy turned in a favorable performance in 1979, with real GDP advancing 6.9%. The driving forces were strong export growth—both of goods and services—and an acceleration in the rate of overall fixed investment. Merchandise exports, which consisted mainly of crude oil and textiles, soared by 69% in 1979. Investment rose 10% in real terms, reaching a level equivalent to 30% of nominal GDP. Significantly, the share of total investment financed by the central government declined, indicating an increased private-sector role. The authorities' conservative monetary management, as reflected in the reduction of money supply growth to 16% from 20% in 1978, contained the rise in the official consumer price index to 7.8% in 1979. That rate of inflation was up slightly from the previous year because the government raised the prices of some basic food items and decontrolled others to limit the growth of a food subsidy bill that accounted for 11% of budgeted outlays in 1979.

On the external front, Tunisia's trade deficit widened to $922 million from $874 million in 1978. The 69% jump in merchandise export earnings was more than offset by large increases in imports of energy and agricultural commodities. A more-than-doubling of services earnings, however, narrowed the current-account gap to less than $300 million, and heavy capital inflows gave Tunisia a balance-of-payments *surplus* of $102 million in 1979.

The 6.9% pace of inflation-adjusted economic growth is estimated to have been sustained in 1980, largely on the strength of exports. The official target of 8.1% was missed because of smaller-than-projected rises both in government investment and in the output of major sectors of the economy.

Total investment rose only about 0.5% in real terms last year, because of shortfalls in public-sector capital formation. The reduced public-sector role stemmed from the government's deliberately delaying the implementation of several major projects. The delays reflect the authorities' increasingly cautious management of the public investment program, which is aimed at maximizing long term benefits to the economy. The short-term trade-off, however, was the creation of fewer new jobs than had been targeted to help absorb the rapid labor force expansion. The workforce's fast growth is the product of a 2.7% annual population increase, the greater participation of women, and the return home of a growing number of Tunisians from abroad—particularly from Libya with whom relations are still strained following the January 1980 Libyan-sponsored terrorist attack on the phosphate-mining town of Gafsa.

MAIN ECONOMIC INDICATORS

	1978	1979	1980 est.
Nominal GDP ($ million)	5,954	6,981	8,200
Real GDP growth, %	8.9	6.9	7.0
Investment as % of GDP	29.2	30.2	29.0
M2 growth, %	20.0	16.0	16.0
Inflation rate, %*	6.2	7.8	9.0

*Annual rate of change in the official CPI

The slow growth in investment last year was accompanied by only a slight increase in agricultural output, a slowdown in manufacturing, and the beginning of a downtrend in the production of crude oil. Crude output fell 6% to 5.2 million tons last year, after peaking at 5.5 million tons in 1979. Phosphate rock and fertilizer output, however, rose significantly.

In keeping with the strategy of 1979, public-sector activity eased further and monetary management remained cautious. Money supply growth approximated the 1979 rate, and a sharp decline in net bank claims on the government more than offset the rise in net foreign assets and the faster growth of credit in the

Tunisian Economy on Right Track

private sector. The rate of inflation, however, i
mated to have crept up to 9%-10% from 7.8% in
A main reason once again was higher prices for
foodstuffs aimed at limiting the size of the go
ment's subsidy bill.

The external economy held its own in 198
fueled much of the domestic growth, althou
performance was weaker than in 1979. Mercha
exports were up some 30%. Oil export volume fe
certain foodstuff exports were down, but phos
exports climbed steeply. Nonetheless, growth o
ports (particularly of energy and food) outpace
of exports, a trade deficit of $1.0-$1.1 billion is
mated for last year, with a current-account g
$300-$400 million. The overall balance-of-pay
surplus is estimated to have shrunk to aroun
million.

The 1981 outlook

Although the government projects real GDP g
to drop to 6.7% this year, it is more likely to r
around 7%. Oil production is expected to fall f
and expansion of tourism is likely to be modest
investment spending by the government is bud
to rise, and continued ouput and export gains ar
for phosphates. Also, prospects for some agricu
crops are favorable.

The domestic economy will receive an added
this year because of more expansionary fisca
monetary policy. Central government expenditur
projected to rise 18% over 1980, and both publi
private investment are set to climb substantially
priority areas in the 1981 budget are agricultur
fisheries, industry, and national defense. Mo
growth will accommodate the higher level of p
sector activity; the money supply is forecast to e
by around 18%. As a result of these added sti
and the likelihood of further basic foodstuff
rises—the consumer price inflation rate is lik
climb by one or two percentage points.

BALANCE OF PAYMENTS
(millions of dollars)

	1979	1980 est.
Trade balance	−922	−1,050
Current-account balance	−298	− 350
Capital inflow	400	365
Overall balance	102	15
Foreign-exchange reserves	579	590

For the external economy, a widening in the c
account gap to some $450 million is expected. T

(continued from page 7)

sons include slower growth in net oil exports and reduced worker remittances and tourism receipts, coupled with increased imports of capital goods and production inputs. But a continued large inflow of foreign official credits and a higher level of foreign direct investment—stimulated by legislation aimed both at boosting foreign investment and disbursing it geographically—should easily offset most of this gap.

Tunisia's favorable external-debt position stems largely from the fact that the lion's share of its debt is owed to official lenders on concessional terms. Indeed, publicized capital-market borrowing (mostly in the Euromarket) has fallen steadily since 1978, totaling only $12 million during the first half of 1980. Fully 67% of the $2.8 billion in total outstanding and disbursed debt as of December 1979 was owed to foreign governments and international organizations. The debt service relative to current-account receipts was a comfortable 11%. External debt last year is officially estimated to have climbed to $3.1 billion, but the debt service ratio rose only slightly—to 11.1%. External debt is officially forecast to reach $3.4 billion by end-December 1981, with the debt-service ratio expected to rise only marginally to 12.3%.

Outlook over the longer term

Tunisia's growth pace of the past few years is likely to continue for much of the 1980s. The economy's emphasis on investment, its conservative fiscal management, and its well-balanced development programs point to sustainable growth in the medium term, assuming continued sociopolitical calm. The country's current-account deficit is expected to widen over the next few years because of rising food imports, falling oil exports, reduced remittances, and uncertain prospects for agricultural exports—combined with an ambitious investment program as part of the sixth development plan (1982-86).

Tunisia may need to resort more frequently to the international capital market than it has in the past five years to finance its future current-account deficits. But its dependence on such sources should not prove excessive, given the strong likelihood of a continued large inflow of official foreign assistance, mostly on concessional terms. More significantly, larger inflows of foreign private investment are highly probable, and direct investment from Arab oil-producing countries will grow substantially. In addition, the government plans to spur export promotion and import substitution in all major sectors, give priority to expanding agricultural output, and step up exploitation of natural gas reserves.

Sharif Ghalib

CHASE

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U.S. Foreign-Exchange Intervention Halted

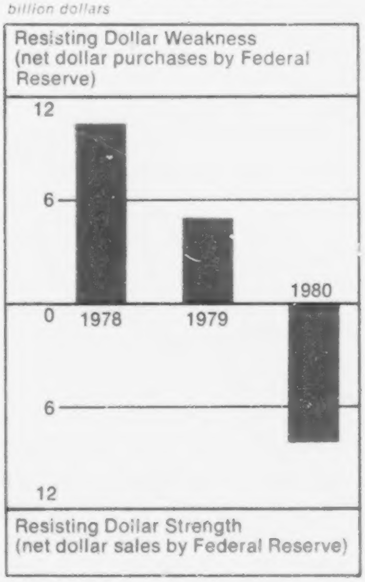
The U.S. Treasury announced a major change in U.S. foreign-exchange intervention strategy last week that should improve the conduct of U.S. domestic monetary policy. The Federal Reserve System--operating through its foreign-exchange trading desk at the New York Federal Reserve Bank--will no longer intervene in the foreign-exchange markets, except in emergencies. This shift should have no effect on the dollar's foreign-exchange value or on worldwide foreign-exchange markets, since the magnitude of U.S. intervention activities has historically been small compared with the total size of actual and potential foreign-exchange transactions. The change should, however, make for a more consistently applied U.S. monetary policy.

For example, last winter there was a basic conflict in the tactics employed by the Federal Reserve's foreign-exchange desk and the Domestic Open Market Desk. The foreign desk was a net purchaser of foreign currencies—usually German marks—and thus a supplier of dollars to world money markets. The domestic desk, which operates in volumes many times the size of the foreign desk, was attempting during this same period to constrain the growth of the money supply. Thus, the domestic desk consistently offset the impact of the foreign desk's transactions on world money markets.

This inconsistency in basic operations by the Federal Reserve has been addressed in the intervention strategy imposed by Treasury Undersecretary Sprinkel. If the United States adopts a fundamentally more restrictive monetary policy than its trading partners, policymakers should anticipate that the dollar will strengthen. To resist this dollar strength through market intervention is fruitless even when this intervention is carried out on a day-to-day basis with the objective of reducing exchange-rate volatility.

The presumed basis for the new strategy is the proposition that foreign-exchange markets are linked closely to domestic money markets. Indeed, most international banks locate their foreign-exchange and money-market dealers in the same trading room with access to the same information, which they can share. This makes for extremely efficient markets that are tightly linked. With the new intervention strategy, the Treasury has acknowledged that attempts to play one market against another are not viable operational strategies for the Federal Reserve.

U.S. intervention in currency markets



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Denmark's economic improvement may be short-lived.

Denmark's proclivity for stretching its resources and piling up huge foreign debts persists, but recent developments point to some improvement in the domestic economy. Last year's trade deficit narrowed to $2.4 billion from $3.6 billion in 1979, and preliminary deficit figures for January and February 1981 were below those for the same two months in 1980. The rate of inflation, which threatened to exceed 14% for much of 1980, has been kept to 10% since the fourth quarter of last year. Moreover, recent private-sector wage negotiations suggest that earnings will rise by some 7% this year and next, thereby holding Denmark's costs in line with those of its trading partners. Looking further ahead, North Sea gas is expected to supply 30% of Danish energy needs by 1984 and a larger proportion thereafter. Nonetheless, the near-term outlook is less encouraging. The trade deficit remains large, and overseas debt is growing rapidly. In addition, much of the recent improvement in the deficit and inflation has been bought at the expense of a deep recession. As time passes, the pressure on the government to stimulate the economy is likely to intensify—which will then aggravate key economic indicators.

New Dutch measures aim to boost investment and exports.

In an attempt to direct resources away from consumption toward investment and exports, the Dutch government last month announced cuts in government spending, more aid to industry, and higher fuel and social insurance taxes. Total government spending is to be reduced over previous plans by 2.5% to 4 billion guilders for the year, and higher excise taxes on gasoline and diesel fuel will raise an additional 250 million guilders in revenue. Special aid will be channeled to the building industry, firms in financial difficulty, and the unemployed young. On balance, the measures should cut the government's financing deficit to 6.75% from 7.5% and dampen consumer spending by 3%-5%. These measures, together with the higher prices for Dutch gas exports negotiated last year, should help reduce the 1981 current-account deficit from the 4.9-billion-guilder ($2.3-billion) gap recorded last year.

Current-account deterioration to accompany Greece's economic rebound.

Despite a slowdown in economic growth, Greece's balance-of-payments gap expanded last year. Real GDP growth was only 1.3% in 1980, versus 3.9% in 1979, yet the current-account deficit widened to $2.06 billion from $1.88 billion the year earlier. The major cause was a $1-billion rise in net oil imports to some $2.7 billion, without which the current account would have shown substantial improvement. Non-oil imports actually declined by 2% in value and by substantially more in volume. A reflationary budget and some easing of monetary policy are officially expected to lift the rate of real economic growth to about 2.7% this year and to push the current-account deficit to some $2.4-$2.5 billion. The latter range might prove optimistic, however, if expectations of a $3.6-billion annual oil bill our fulfilled. The inflation rate, currently about 26%, is officially projected to decline to approximately 21% by yearend. The outlook beyond yearend, however, is clouded by uncertainty regarding the outcome of the forthcoming elections—due by November—and the policies that the new government will pursue.

Flurry of Panamanian investment projects buoying local economy.

The recently brisk pace of Panamanian economic activity stems largely from a number of major projects either planned or under way. The new development plan being prepared stresses projects that exploit more fully the country's resources and geographic location. In the energy field, three major hydroelectric facilities have either been completed or launched, while plans are set to extend electrification to rural areas now without electricity. Another major investment planned is the building of a Trans-Isthmus pipeline to transport oil from the Pacific to the Atlantic coast of the country. These projects supplement the recently constructed international airport, fishing port, and convention center. Together, all of the ongoing and planned projects should have multiplier effects sufficient to assure real economic growth of 5% or more in 1981.

Peru's economic growth rate eased some in 1980.

The Peruvian economy recorded real growth of 3.1% in 1980, down slightly from the 3.8% recorded in 1979. The small deceleration was the product of a 5.5% decline in agricultural output, owing to poor weather, and a 3% drop in mining's contribution, attributed to the disincentive of low world mineral prices and to strikes. Manufacturing and construction performed well, however, rising by 7% and 18%, respectively, compared with growth of about 3.8% each in 1979. The rate of inflation equalled 60% last year, on a fourth-quarter-to-fourth-quarter basis, a rate that has been sustained so far this year because of adjustments in food and fuel prices and interest rates, wage increases, and continued expansionary monetary and fiscal policy. In the external sector, the shift to import liberalization, aimed at checking inflation, raised imports to $3 billion from $1.9 billion in 1979. With exports rising only moderately to $3.9 billion from $3.5 billion the year earlier, Peru's trade surplus declined to $825 million last year.

Korean economic recovery under way.

Korea's economy now appears to have turned the corner after a tumultuous 1980. The country registered negative real economic growth of 5.7% last year, accompanied by an inflation rate of 35% and extreme political turmoil. President Chun Doo-Hwan's government, which won a solid electoral mandate recently, is committed to leading the country on the road to renewed takeoff. Various government initiatives designed to boost domestic and international confidence in Korea are having notable psychological effects, but actual economic benefits must await an upturn in world trade and a further decline in inflationary pressure. Meanwhile, heavy import requirements associated with the economic recovery will keep the current-account deficit large. External borrowing needs will thus continue high, at about $7 billion. Overall, Korea is likely to see real economic growth of 5%-6% this year and an easing of the inflation rate to about 20%.

UAE current-account surplus widened by more than 65% in 1980.

The United Arab Emirates, an OPEC member, registered a current-account surplus of an estimated $9.5 billion in 1980, up sharply from approximately $5.75 billion in 1979. The marked improvement—attributable to Abu Dhabi and Dubai, which account for virtually all oil production in the UAE federation—occurred despite a cut of 7% in Abu Dhabi's oil output last year to an average of 1.7 million barrels per day. It reflected a 59% increase in the weighted average sales price of UAE oil, which rose from about $19.70 per barrel in 1979 to $31.40 per barrel last year. Export revenue was up 48% in 1980, totaling $20.2 billion, fueled mainly by gross oil revenues of $19.4 billion. At the same time, imports of goods (not re-exported), services, and private—as well as official—transfer payments rose 40% to some $13.5 billion, reflecting a pick-up in domestic economic activity. Finally, non-oil earnings of approximately $2¾ billion—mainly from foreign assets—brought the overall current-account surplus to $9.5 billion. The probability is high that the UAE surplus will narrow significantly this year in view of sluggish demand for OPEC oil, the likelihood that official oil prices will remain stable over the remainder of the year, and a continued expansion in imports.

Reduced feed grain supplies imply price rises in second quarter.

Prices of coarse or feed grains look set to rise during the second quarter of 1981. It is estimated that world coarse grain supplies for the 1980-81 crop year will be about 808 million metric tons, the lowest since 1977-78. Increasing commitments by many countries to expand livestock production suggest consumption of 750 million tons in 1980-81. As a result, coarse grain stocks are projected to be about 62 million metric tons at the end of 1980-81, equivalent to only 8.4% of utilization. This compares with ending stocks of 88 million tons in the crop year 1979-80 and with a previous low stock-utilization ratio of 8.8% recorded in 1975-76. The price of No. 2, Yellow, Chicago corn—corn accounts for roughly 65% of total coarse grain supplies—is likely to average around $3.85 per bushel in the second quarter of this year, compared with an average price of $3.50 for the first quarter. These prices are well above the 1980 average of $3.01 per bushel.

Recent Money Bulge May Be Reversed

Growth in one of the most widely watched measures of the money supply has surged over the course of recent weeks. In the four weeks ended April 8, M1-B grew at a seasonally adjusted annual rate of 13¾%. And from March 25 to April 1, M1-B rose a whopping $8.1 billion. Such growth, if sustained, could portend a sizable rise in money-market rates in the near future. There is reason to believe, however, that much of the recent jump in M1-B is the result of technical seasonal-adjustment problems that will soon be reversed.

M1-B consists of currency, demand deposits, and "other checkable deposits"—such as NOW accounts—at banks and thrifts. To arrive at seasonally adjusted M1-B, each component is seasonally adjusted individually—except for other checkable deposits. This is presumably because there has not been enough experience with this component to permit a scientific estimation.

The potential magnitude of the effect uncaptured seasonal movements in other checkable deposits may have on M1-B growth has increased significantly since January, when NOW accounts were introduced nationwide. Since last December, other checkable deposits have risen from $27 billion to $63 billion, or from 6½% to 15% of M1-B. If seasonal movements in these deposits are similar to the wide seasonal fluctuations in demand deposits, such movements could have a profound impact on short-run M1-B growth.

The Federal Reserve's seasonal factors suggest that seasonal forces cause unadjusted demand deposits to rise by 5.1% between March 25 and April 8. If 60%-75% of other checkable deposits behave similarly to demand deposits—a reasonable assumption, given Fed estimates—then these seasonal factors suggest that a seasonal rise in other checkable deposits woud push up M1-B between March 25 and April 8 by about $2 billion. In actuality, other checkable deposits rose $6.1 billion during these two weeks.

The above seasonally adjusted estimate probably *understates* the actual seasonal component of other checkable deposits. Almost all such deposits are held by households, and the seasonal rise in household deposits in April is traditionally larger than that of total demand deposits—by about 2.2%. This implies that the seasonal rise in other checkable deposits from March 25 to April 8 was closer to $2½ to $3½ billion. It also suggests that the failure to seasonally adjust other checkable deposits may add as much as 5½ to 8½ percentage points to annualized M1-B growth in April.

Households, however, tend to run down their demand-deposit holdings from mid-April to May about as fast as they run them up from mid-March to mid-April. Consequently, any *seasonal* rise in "other checkable deposits" in April should be completely reversed by mid-May.

Investment Aids GNP Surge

Strong business investment was a major contributor to the surprising 6.5% rise in real GNP reported by the Department of Commerce for the first quarter of 1981. Only last month, Commerce had projected a 5% climb in GNP, and some analysts had expected a weaker figure because March retail sales rose only 0.1%, despite booming auto purchases. But strong investment by business in the first quarter—more than 12% growth at an annual rate—helped pave the way to a larger GNP increase.

The recession last year was brief but extremely sharp, leading to a fall in GNP that was just about as severe as the average decline for post-war recessions. But the drop in investment spending was only about two-thirds as steep as the drop in investment accompanying the average business downturn. And investment's rebound in the last six months has been considerably stronger than expected.

The briefness of the recession has contributed to the strong investment performance. The five previous recessions lasted, on average, nearly twice as long as the 1980 downturn. With reduced cash flow over such an extended period of time, businesses were forced to cut back spending quite sharply. But with the quick turnaround of the economy last year, there was little need for businesses to interrupt their spending plans on a massive scale.

The strength in investment, however, has not been broad-based. The buoyancy of first-quarter investment is entirely attributable to greater purchases of autos (in response to manufacturers' rebates), office and commercial construction, and equipment and furnishings for these stores and offices. These three components have skyrocketed at an annual rate of 30% over the last two quarters, while investment in all other sectors has posted a meager 1% increase—about half the pace of previous recovery periods. Indeed, many sectors are still seeing declines in investment. Even the booming petroleum sector, where investment rose by more than 20% during 1980, suffered a setback in the first quarter as oil company profits tumbled.

The improvement in the economy and in profits that followed the 1980 recession was limited, however. Industrial investment growth remained slow, owing mainly to weak profits, which in turn reflected a relatively low level of capacity utilization. The increase in manufacturing profits since last summer has been chiefly the result of smaller losses by the automakers and their suppliers; profits in virtually every other industry are still below year-ago levels. And with capacity utilization still below 80%, there is little incentive to increase investment.

Without a resurgence of industrial investment, the recent strength in total investment is unlikely to be sustained. A tax reduction for businesses, via accelerated depreciation, may spur some speed-up in business investment plans, but a healthier operating rate is essential for any sustained investment increase.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	12-month changes: consumer prices	12-month changes: latest data	12-month changes: money supply(M1)	exchange rate in U.S. dollars April 22, 1981	change from year earlier April 22, 1981	current monetary conditions	
Argentina	Important new tax, tariff, and currency measures taken to promote exports and spur local output.	Dec.	+ 3%	117.0	$4,333	Dec.	6,719	— 28%	8.9	0	Argentine peso devalued by 22.8%.	Mar.	+ 82%	Nov.	+ 99%	.00040	—29%	High interest rates begin to decline.	**Argentina**
Bahamas	Slow economic growth in U.S. and Europe contributes to decline in tourist arrivals.	Feb.	— 4%	1.2	5,630	Feb.	98	+ 12%	0.1	0	Foreign real estate investment falls.	Dec.	+ 12%	Dec	— 1%	1.01	+10%	Central bank stresses domestic business loans.	**Bahamas**
Barbados	Government budget for 1981-82 includes large increase in capital spending.	Aug.	+ 67%	0.8	3,055	Feb.	77	+ 14%	1.8	3	Tourist arrivals fell slightly in 1980.	Nov.	+ 15%	Jan.	+ 16%	.5200	- 5%	Prime rate rises from 8% to 10%.	**Barbados**
Bolivia	Agreement reached on rescheduling $420 million due international commercial banks by April 1983.	Oct.	+ 21%	6.1	1,100	Feb.	138	+ 11%	1.8	77	Gross foreign reserves fell by 40% in 1980 to $106 million at yearend.	Dec.	+ 24%	Dec.	+ 44%	.0425	- 4%	Liquidity squeeze in evidence.	**Bolivia**
Brazil	Industry slows down as demand responds to restrictive money, credit, and fiscal measures.	Feb.	+ 29%	237.2	1,991	Oct.	5,568	— 39%	2.6	0	New 15% tax subsidy granted manufactured exports.	Mar.	+121%	Feb.	+ 68%	.0135	—35%	Foreign loan inflows grow strongly.	**Brazil**
Chile	CORFO intends to sell seven subsidiaries and one bank to private sector.	Nov.	+ 9%	22.8	2,060	Feb.	3,124	+ 46%	6.1	107	Capital inflows respond to large interest differentials and fixed exchange rate.	Feb.	+ 29%	June	+ 65%	.0256	0	Syndicated dollar loans on rise.	**Chile**
Colombia	Mining sector—gold, emeralds, coal, nickel—assuming more importance in the economy.	Dec.	— 11%	36.8	1,360	Feb.	4,761	+ 19%	12.6	0	Book and magazine exports supplement coffee earnings.	Dec.	+ 26%	Dec.	+ 28%	.0190	—13%	Local credit availability improves somewhat.	**Colombia**
Costa Rica	Authorities plan to increase irrigation network and improve highway system.	Dec.	+ 2%	5.0	2,190	Feb.	102	+ 14%	0.8	54	Six-month, interest-fee import deposit plus 1% import surcharge imposed.	Dec.	+ 18%	Dec.	+ 17%	.0750	—36%	Monetary policy is restrictive.	**Costa Rica**
Ecuador	Oil production rate up to 225,000 barrels daily as result of new producing fields.	Dec.	+ 14%	9.2	1,100	Feb.	803	+ 3%	4.1	0	Monetary reserves decline because of larger debt payments.	Mar.	+ 14%	Jan.	+ 28%	.0375	- 6%	Credit restraint spurs higher interest rates.	**Ecuador**
El Salvador	Real GDP in 1980 estimated to have fallen about 9% because of political turmoil.	Sept.	+ 3%	3.8	780	Feb.	92	— 7%	1.1	7	U.S. plans $126-million loan as net reserves approach minus $100 million.	Dec.	+ 19%	Jan.	+ 3%	.4025	+ 1%	Liquidity is tight.	**El Salvador**
Jamaica	Government undertaking stabilization program within context of an $700-million IMF arrangement.	Nov.	+ 26%	3.2	1,460	Jan.	121	— 4%	1.2	297	Some imports channeled to "parallel" foreign-exchange market.	Nov.	+ 30%	Oct.	+ 55%	.5700	+ 2%	Credit policy is restrictive.	**Jamaica**
Mexico	Oil production level of 2.6 million barrels daily makes Mexico number four in world output.	Dec.	+ 64%	167.0	2,300	Sept.	2,603	+ 38%	1.4	0	Investments in U.S. border industries increase.	Jan.	+ 28%	Dec.	+ 33%	.0418	- 4%	Short-term peso loans at 28%-30%.	**Mexico**
Nicaragua	Commerce and construction posted large gains in 1980; repeat peformance expected this year.	Dec.	— 17%	1.8	695	Nov. '79	85	+ 42%	4.5	47	Cotton production projected to rise 30% in 1981.	Dec. '79	+ 68%	Aug. '79	+ 55%	n. a.	—	Credit limits set by industry category.	**Nicaragua**
Panama	Construction of Trans-Panama oil pipeline between Pacific and Atlantic coasts planned.	Oct.	+ 22%	3.5	1,805	Jan.	82	— 28%	0.7	37	Additional IMF credits granted.	Jan.	+ 15%	Dec.	+ 10%	Par	—	Offshore banking activities increase.	**Panama**
Paraguay	Large new bridge planned to link Paraguay with Argentina over the Parana River.	Nov.	+ 5%	4.6	1,505	Feb.	746	+ 23%	13.9	0	Trade with Brazil steps up.	Nov.	+ 11%	Nov.	+ 18%	.0080	0	Local loans limited.	**Paraguay**
Peru	Contract signed with Superior Oil for exploration and development in northern jungle.	Sept.	0	17.2	965	Nov.	1,922	+ 63%	8.2	433	Current-account gap of $68mn. in 1980, versus surplus of $710 mn. in 1979.	Mar.	+ 58%	Nov.	+ 55%	.0026	—28%	Money growth continues at fast pace.	**Peru**
Uruguay	Central bank announces devaluation schedule through Sept.—to be supported via intervention.	Dec.	+ 23%	8.9	3,025	Dec.	473	+ 24%	3.6	0	Foreign reserves at $1.2 billion, with capital inflows heavy.	Dec.	+ 43%	Sept.	+ 32%	.0990	—13%	Interest rates declining.	**Uruguay**
Venezuela	First major contract in Orinoco Heavy Oil Belt awarded.	Nov.	+ 22%	51.4	3,690	Feb.	7,008	+ 6%	7.7	0	Authorities believed to be planning to raise $3-$4-billion Euromarket loan.	Jan.	+ 21%	Oct.	+ 17%	.2335	0	Credit availability limited.	**Venezuela**

World Interest Rates

market rates of Apr. 22, 1981; bond yields as of Apr. 17, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00 penalty large banks 16.00	17.16	12.00	15.00	9.50	7.50	19.00 penalty rate 22.00	9.00	4.00	6.25
Day-to-Day Money	15.75 Apr. 23	18.00	12.00	15.75	12.25	11.25	19.75	10.00	5.75	7.1875
Treasury Bills 91-day, Middle Rates	13.55	16.95	11.28	17.25	13.69 one-year	n. a.	17.60 99 day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	14.25 finance paper	17.35 finance paper 15% tax w/h	11.31	14.90 Certified	13.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.75	17.30 15% tax w/h	11.56	14.90 Certified	not traded	9.90	21.65	no market	n. a.	no market
Government Bonds Long-term, new and old issues, average yield	13.56	14.75	13.69	12.315 20% tax w/h	14.295	10.07	18.38	11.30	5.45	7.801*
Industrial Bonds prime, long-term, new and old issues, average yield	13.95 Aa Industrials	15.50	14.47	18.728	15.45	10.34	18.87	11.99	6.256	7.06*
Bank Short-Term Rate to Best Borrowers (prime rate)	17.50	18.25	13.00	19.25	14.35	13.75	22.50 ⅛ quarterly fee on outstdng.	12.00	8.00	6.75
Bank Time Deposits 3-month	14.75 Cert. of Dep.	16.75	12.375	17.10	13.25	13.15	10.75	10.50 large deposits	8.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	16.3125	no market	12.375	no market	12.6875	12.50	no market	10.5625	9.0625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8361	2.1800	.0282	.1949	.4613	.000923	.4153	.5050	.004603
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.25 *D*	3.875 *P*	1.125 *D*	2.625 *P*	3.50 *P*	3.375 *D*	5.50 *P*	7.00 *P*	8.75 *P*

Eurodollar Deposits
(London, interbank, bid)
April 22

7-day	**15.625**
1-month	**15.00**
3-month	**16.25**
6-month	**16.125**

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.452
U.S.-Canada Treasury Bills	−1.22
U.S.-Canada Finance Co. Paper	−1.612
Eurodollars-U.K. Local Auth. Deposits	+ .125

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.75
Over 7 yrs.	14.50
DM Bonds	
7 yrs. and under	10.25
Over 7 yrs.	10.00

Gold Price
London
afternoon fixing

501.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Bond yields as of April 10.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	10.6 (Mar.)	12.4 (Mar.)	12.6 (Mar.)	12.7 (Feb.)	5.5 (Mar.)	20.1 (Mar.)	6.3 (Mar.)	6.5 (Feb.)
Industrial production*	−0.3 (Mar.)	−0.5 (Jan.)	−9.3 (Feb.)	9.6 (Feb.)	2.0 (Feb.)	3.6 (Feb.)	1.0 (Dec.)	0.1 (Feb.)
Trade balance† *(billions of local currency units)*	−$3.15 (Feb.)	C$0.54 (Feb.)	£0.31 (Feb.)	−FF4.61 (Mar.)	DM0.86 (Feb.)	−Lit.1,530 (Feb.)	−SF0.80 (Mar.)	¥449 (Mar.)
Money supply (M1)*	7.7 (Mar.)	6.7 (Jan.)	5.9 (Dec.)	11.1 (Nov.)	5.8 (Jan.)	13.7 (Nov.)	−5.7 (Nov.)	1.8 (Dec.)
Velocity of money (M1)*	4.6 (Dec.)	−0.14 (Dec.)	8.7 (June)	n. a.	0.6 (Dec.)	6.6 (Sept.)	n. a.	12.6 (Sept.)
Reserves minus gold *($ million, change from previous month)*	1.370 (Feb.)	79 (Feb.)	152 (Feb.)	912 (Feb.)	1.759 (Feb.)	1.464 (Feb.)	672 (Feb.)	249 (Feb.)

* Percent change from 12 months earlier

† Figures are only for the month indicated.

Spanish Economy in Low Gear

The Spanish economy is faced with rough going again this year after an anemic performance in 1980. Real economic growth last year was a scanty 0.5%-1.0%. The only bright spot was agriculture, where output was of bumper proportions. Otherwise, industrial output declined 1% over the first nine months of the year, and tourist arrivals as of November 1980 were down 1.5%—in response to high prices and the threat of terrorism. Aggregate demand was especially weak in the face of a surge in unemployment. Only public consumption was strong, at the cost of a steadily expanding budget deficit.

Things are unlikely to improve this year. The domestic economy is languishing, with agricultural output hurt by drought and investment spending curtailed by political uncertainty. The public-sector deficit continues to swell, renewed price pressures have emerged, and unemployment remains precariously high. The external economy is also in difficulty. The balance of payments is in substantial deficit, and worldwide recession will dampen exports at least through midyear. Meanwhile, the peseta continues to depreciate steadily and rapidly on the foreign-exchange markets. All in all, real economic growth in excess of 1.0%-1.5% appears unlikely in 1981—despite the expansionary impact of the ever-widening public deficit.

A budget deficit out of control

Spain's growing public-sector deficit constitutes a serious fundamental problem, which the authorities have yet to address in earnest. The 1980 budget gap totaled 315 billion pesetas (about $4 billion), nearly double the 1979 shortfall and equivalent to some 2% of GNP. The 1980 deficit was partly the product of recession, as revenues registered a 2.5% decline. But the major culprit was broad-based overspending, a pattern that appears unlikely to be reversed.

The widening deficit also played havoc with the domestic financial market late last year. World financial markets were already in upheaval with U.S. dollar interest rates at record levels. The combination of a weakening peseta and high dollar interest rates thus led to a flow of funds out of Spain and an easing in the fast pace of money supply growth—to 16% in December from 17.8% in September. With declining liquidity and rising public demand for funds, interest rates rose and private borrowing tended to be crowded out. Although the monetary authorities have moved to liberalize the domestic financial system—by abolishing interest-rate ceilings on most credits, freeing interest rates for deposits of more than six months' maturity, and clarifying rules on bank commissions—Spain's still-rigid financial system, a holdover from the Franco era, remains far from liberalized.

The rapidly depreciating peseta, together with imported-fuel price increases and rising food prices, has touched off renewed price pressures in the Spanish economy. The year-over-year rate of price increase was 14.4% in January, and although official forecasts call for a reduction in the rate of inflation to 13.5% in 1981, this appears overly optimistic given the still-high rate of money growth and the peseta's weakness.

Wages have managed to keep up with inflation, despite the sharp deterioration in the employment situation. Preliminary estimates place the growth of inflation-adjusted wages at about 1% in 1980. Nonetheless, over the same period, the number of unemployed Spaniards jumped 350,000 to 1.5 million—or 12.6%, the highest unemployment rate in Europe.

On the external front, the balance-of-payments reversal has been dramatic. Ironically, it was only in April 1979 that measures were taken to liberalize imports to reduce heavy capital inflows. But the steep oil price rise of 1979-80 hit hard. Preliminary figures show that the current-account balance deteriorated by $6 billion over the course of 1980, leaving Spain with a deficit of $4.8 billion for the full year. The oil bill increased by $4 billion to $12 billion; at the same time, export volume growth was a weak 1%, owing to lagging foreign demand, while imports grew 5%, partly in response to the still-effective 1979 liberalizations. And tourist receipts failed to post increases. The peseta weakened in response to the external-account worsening, declining 16.5% against the U.S. dollar in 1980 (13.2% on a trade weighted basis). This weakness has continued into 1981, with the peseta slipping in line with the German mark.

Spain's long-term prospects are favorable, owing to its strong and diversified resource basis and because of its imminent membership in the European Economic Community. Moreover, although it is expected to remain dependent on imported oil, Spain should be able to finance its balance-of-payments shortfalls without incurring a debt-servicing problem.

The short term, however, offers little cause for optimism. The peseta's depreciation has improved the competitiveness of Spanish exports and has bolstered tourism. But any export-led recovery is not likely to be significant until the world recession begins to reverse itself—possibly in the second half of the year. In any event, the balance-of-payments deficit is not expected to be reduced in 1981. This will keep the peseta weak and contribute to sustaining high inflation. Domestically, there is no sign of any upturn, and political instability is likely to delay any incipient upturn.

Peter A. Davies, Chase London

Prime-Based Euroloans

New to Eurocurrency market financing is the syndicated loan that is priced at a spread over U.S. bank prime, rather than over the London Interbank Offered Rate (LIBOR). Borrowers must pay a spread over U.S. bank prime that is adjusted daily or weekly, rather than every three or six months, as it would be in a three- or six-month LIBOR-keyed loan. To protect borrowers and lenders from major deviations between the prime rate and market rates–since the prime is bank-administered rather than market-determined–there may be a negotiated "cap" and/or floor on the maximum allowable spread above or below 90-day certificate-of-deposit (CD) rates, adjusted for reserve requirements.

Euromarket *lenders* are likely to be amenable to the prime-based pricing option. From their perspective, the issue is whether prime-based pricing introduces a greater risk between pricing and funding costs. A major Eurobank may choose to fund a prime-based loan with Eurodollars. If the spread between three-month Eurodollars (interbank) and prime shifts, the lender reaps the gain or absorbs the loss. Prime has historically been higher than LIBOR–reflecting the reserve requirements on U.S. bank deposits–so that spreads over prime are lower than spreads over LIBOR. Even with narrower spreads, however, prime-based loans do provide lenders a small premium for bearing increased funding-cost risks.

The incentives are perhaps strongest for U.S. regional-bank lenders, which are not active participants in either the foreign-exchange or London interbank markets. These banks cannot always fund in the London interbank market on the same fine terms as the larger Eurobanks, but they do have access to competitive funding in the U.S. domestic market. Indeed, prime-based loans are ideally suited for these banks since they are already accustomed to pricing loans on a prime-rate basis.

Borrowers assume some added risks with prime-based, as opposed to LIBOR-based, credits, but these are offset by the opportunity to tap U.S. regional banks as an incremental funding source. Essentially, the borrowers' risks are concentrated in the predictability of the prime-LIBOR relationship. If the loan has a cap option, such that the loan rate can diverge only so much from U.S. CD rates, this risk is substantially reduced. In general, the major risk associated with prime-based Euroloans is that additional reserve-requirement regulations may be imposed on domestic U.S. banking versus Eurobanking–which would result in prime-based loans being more costly than those tied to LIBOR. The Monetary Control Act of 1980 set a trend toward reducing reserve requirements on U.S. banking, but the trend was upset with the temporary imposition of marginal-reserve requirements on bank-managed liabilities in the spring of 1980. There is, however, at least the possibility of costly regulations being imposed on Euromarket activity also. In either case, syndicated loan agreements specify that the borrower bears the risk. Finally, an intangible, but perhaps equally important, advantage of prime-based loans for certain borrowers is the symbolic or psychological value of lower spreads.

All in all, the prime-based loan pricing option is essentially a response to the need of regional U.S. banks–particularly the smaller regionals–for a pricing mechanism that more closely reflects their usual asset/liability-management practices. Thus, the success or failure of these new loans will depend upon whether they attract additional regional-bank participation in Euroloan syndications.

Bluford H. Putnam

Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	IQ/80	IIQ/80	IIIQ/80	IVQ/80	1978	1979	1980
Gross Size (Claims)	1,117.4	1,206.0	1,247.8	1,275.0	893.1	1,110.7	1,275.0
Net Size (Claims)	675.0	745.0	775.0	785.0	535.0	665.0	785.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	274.3	279.9	282.8	285.6	222.3	269.5	285.6
Liabilities to Private Nonbank Foreigners	67.7	69.8	71.9	74.9	57.8	65.8	74.9
Total Claims on Foreigners	324.8	347.3	365.0	381.8	281.8	324.0	381.8
Claims on Foreign Public Borrowers	40.9	41.5	45.7	48.4	34.3	41.7	48.4
Claims on Foreign Private Nonbank Borrowers	118.8	129.4	133.3	138.8	104.1	117.9	138.8

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.

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What OPEC is Doing With Its Money

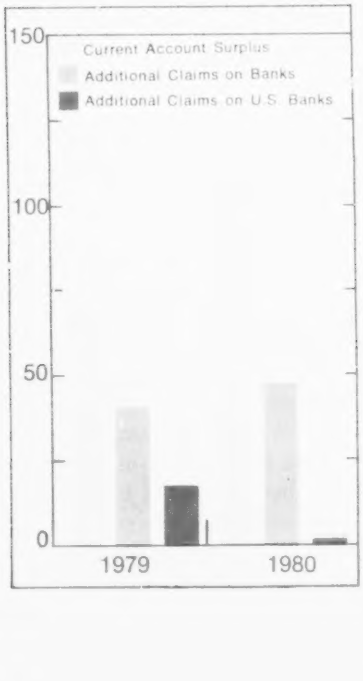
Sufficient data are now available to give a relatively complete picture of how the OPEC countries disposed of the huge $110-billion current-account surplus they accumulated last year. Some $44-$45 billion flowed into deposits with the banking systems of the industrialized countries. Other investments in the industrialized nations—chiefly purchases of government bonds and bills, private-sector debt, and equities—accounted for an additional $33 billion, of which $15 billion represents investments in the United States or claims against non-bank U.S. entities. Some $5 billion was loaned directly on a term basis to the oil-importing developing nations. Another $5 billion was invested in the debt of international organizations. And approximately $15 billion was accounted for by short-term credits for oil exports. When account is taken of foreign borrowing, the unidentified residual would thus appear to fall in the $10-$15 billion range.

There are several features of this pattern of deployment of the OPEC surplus that deserve mention. One is the decline in the proportion of new assets held in the form of bank deposits. In 1979, almost two-thirds of the identifiable additions to OPEC portfolios took this form. Last year this fraction was down to one-half. This pattern of increased diversification as to type of asset closely parallels the events following the first oil price shock, and can be expected to continue.

The most striking development, however, has been the decline in the proportion of OPEC assets held in the form of claims against the U.S. banking system. From the end of 1979 to the end of 1980, the liabilities to OPEC countries of banks in the United States plus major foreign branches of U.S. banks increased by only $1.1 billion, less than 3% of the total increase in OPEC claims against banks in the industrialized countries. The liabilities of the U.S. banking system to Middle East oil exporters actually declined $2.0 billion last year. This is a sharp reversal from 1979, when $16.5 billion of the nearly $40-billion increase in OPEC claims against the international banking system was held with U.S. banks. Although comprehensive data are lacking, this change in OPEC asset preferences does not appear to represent a diminished attraction of dollar-denominated assets, however. Indeed, it would appear that the trend toward diversification away from dollar assets in OPEC portfolios so noticeable in 1978 and 1979 was sharply reduced if not reversed last year.

The disposition of the OPEC surplus

billion dollars



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Canadian real economic growth forecasts revised up.

Latest economic indicators point to a faster pace of Canadian real GNP growth in 1981 than previously forecast. Late last year, the rate of real GNP expansion was projected at 1.0%-1.5%, but most forecasts for 1981 have now been lifted to 3%-3.5%. Reasons include the fast rate of U.S. growth in the first quarter, indications of increased investment spending by Canadian businesses, reasonably good export prospects, and inventory rebuilding in the wake of last year's economic decline. Faster growth, however, is being accompanied by higher inflation, as consumer prices advanced at a 12.5% annual pace in March. Also, Canadian interest rates have climbed in response to higher U.S. rates. These influences suggest that the economy will not sustain vigorous growth throughout the year, but will likely evince quarterly volatility.

Economic activity turns up in Germany, but the cause is still uncertain.

Recent data suggest an upturn in German economic activity. Industrial production rose a provisional 4.5% in February, after advancing 1.8% in January, and February industrial-order volume was up 5.8% above its yearend-1980 level. The gain in order volume came almost exclusively from the export sector, as foreign orders grew some 10% in the first two months of 1981, while domestic orders grew only 2%. The rebasing of the industrial production index in January calls for caution in the interpretation of production figures. But trade deficits in January and March—the product of an import surge—are consistent with stronger economic activity. Sufficient data are not yet available, however, either to confirm the upswing or identify its origins. But several hypotheses may explain the upturn: inventory liquidation may have ended; the personal savings ratio may have fallen; or export demand (especially from OPEC) may have surged. The first two elements would be unlikely to lead to a lasting economic recovery, but a surge in export demand would not only spur recovery, it would also narrow Germany's large current-account gap and permit the central bank to lower interest rates gradually.

Italian economic strength continuing, but weakness threatens.

The Italian economy continues to exhibit remarkable strength. Recently released data show that real GDP rose at a seasonally adjusted rate of 2% in the final quarter of last year, following a 2.7% decline in the third quarter. Moreover, Italy's volatile industrial production index posted a seasonally adjusted 7.5% rise in February after a small drop in January. Trade and inflation figures have confirmed the strength in demand; consumer prices rose at an annual rate of 20% in the first quarter, and trade deficits of 1.5 trillion lira were recorded in each of the first two months of 1981. The economy is expected to slow down in the near future, however, in response to credit restrictions imposed in February and the rise in the discount rate to a record 19%, which accompanied the March devaluation of the lira. If the economy fails to cool down, another increase in Italian interest rates can hardly be avoided.

Irish economic deterioration prompts rumors of imminent general election.

The Irish economy appears to be quickly departing from the course planned for it by the present government. Only three months into the current financial year, and already the budget deficit on current account amounts to some 205 million pounds, as against a target of 515 million pounds for the full year. Public-sector borrowing now threatens to reach 18% of GNP, an all-time record proportion. Inflation has begun to accelerate anew, as confirmed by the huge 2.8% jump in wholesale prices in January. And Ireland is faced with a substantial balance-of-payments shortfall, with the March trade deficit double that of March 1980. Deflation might seem the obvious remedy, but industrial output is already well below last year and unemployment is high and rising. Moreover, the present government was elected in 1977 on the strength of promises to foster a fast and sustained economic growth rate, and it is unwilling to impose deflationary measures. It is clear, however, that some policy changes must be introduced soon. This has prompted widespread speculation that the government will seek reelection shortly and that—if reelected for another five-year term—it will launch a new term with a heavy dose of deflation.

Honduran economic growth contracted sharply last year.

The Honduran economy has not been immune to the recent turmoil elsewhere in Central America, as evidenced by its economic performance last year. A decline in private-sector investment was a major contributor to the deceleration of economic growth to 2% in 1980, which compares with annual average growth of 7.5% in the 1975-79 period. Most of the deterioration was concentrated in construction, manufacturing, and agriculture. In the agricultural area, coffee output dropped about 15%, owing to cyclical forces, while banana output declined approximately 4% because of work interruptions. Since these commodities account for more than half of foreign-exchange earnings, the country's external-payments position was adversely affected. Total exports rose by only 8%, while imports advanced 22%. As a result, the trade deficit—which averaged $100 million in 1978 and 1979—widened to $250 million. This, coupled with a sizable volume of capital flight, led to a reduction in official reserves to $150 million as of end-1980, compared with reserves of $210 million at end-1979.

Economic rebound seen for Hong Kong in second half of 1981.

Export-oriented manufacturers in Hong Kong are troubled by high interest rates and weakness in sales. The high rates have also cooled the property market boom, which has been the second major prop of the economy. With a dearth of encouraging economic developments in recent months, investors' moods have distinctly changed. As a result, Hong Kong's balance-of-payments position has deteriorated. The ensuing exchange-rate weakness has pushed up the annualized rate of inflation to more than 20%. However, all is not lost for 1981. Exporters are expecting strong Christmas shipments, and property developers are anticipating a turnaround in the second half of the year, barring unforeseen adverse political developments. The impending rebound is expected to bring with it a stronger exchange rate and a lower rate of inflation, setting the stage for vigorous growth in 1982.

Sri Lankan progress on budget control in 1981 derailed by added spending.

In an effort to reduce a swollen budget deficit, Sri Lankan authorities implemented in November 1980 cuts of 25% from pre-budget estimates of 1981 capital expenditures. The overall budget deficit for 1981 was then projected at 11.8 billion rupees (about $655 million), and was to be financed entirely through foreign funding and non-inflationary domestic borrowing. No supplemental expenditures were to be permitted. In March, however, the authorities restored funds cut from a water-supply project and some 750 million rupees for the Mahaweli Ganga Development Program. To offset these added appropriations, all other ministries were instructed to cut spending by 10% over and above the November 1980 reductions. Still, the anticipated budget deficit has increased to 12.9 billion rupees—equal to about 15% of forecast GDP—and central bank borrowing of approximately 3 billion rupees will be needed. Although the forecast gap in 1981 is narrower than the 14-billion-rupee deficit of 1980, the government's failure to adhere to its original budget figures by making adequate offsetting cuts demonstrates that it faces an uphill battle in its effort to rein in the budget deficit.

Market fundamentals suggest sugar price rise.

Current world sugar prices of approximately 15 cents per pound are a puzzle to some analysts because they do not reflect market fundamentals. The 1980-81 world sugar crop is expected to be near 87 million metric tons, while consumption is projected at more than 89 million metric tons. This will leave global sugar stocks at the end of crop year 1980-81 (August) at about 21 million tons, reducing the ending-stocks-to-consumption ratio to almost 24% from 26.3% in 1979-80. The last time this ratio was this low—in 1974—prices reached a monthly average of almost 60 cents per pound in November. Possible explanations for the current relatively low price levels are high interest rates, the dollar's strength, and retrenchment by speculators. It has been suggested, however, that U.S. Department of Agriculture estimates of consumption may be on the high side, and that fructose maize syrups may be making greater inroads into sugar consumption. Yet, based on actual market fundamentals of supply and demand, sugar prices would appear likely to be headed higher.

Shaping a Farm Policy for the 1980s

Despite President Reagan's lifting of the Soviet grain embargo last month, little support for administration agricultural policy is evident among Congressional farm policymakers. The President has proposed a major departure from past legislation for the omnibus farm bill that will replace the Food and Agriculture Act of 1977, set to expire September 30. To minimize federal budget exposure and help keep U.S. farm prices competitive in world markets, Mr. Reagan favors ending current support programs of target crop prices and deficiency payments to farmers. Instead, he has recommended what is described as a more market-oriented approach that makes greater use of agricultural loans and systems of crop reserves to provide a "safety-net" for farmers in times of excess production.

Agriculture committees in both the House and the Senate initially balked at the idea of eliminating agricultural subsidies. They essentially scrapped the Administration's proposal and voted to extend potentially expensive support programs the President had sought to do away with. Both committees are due to conclude work on the bill this Friday. However, the final form of the farm legislation—and thus the blueprint of farm policy for the first half of the 1980s--is still uncertain.

The changes in American agriculture and in economic and political conditions that have occurred over the past decade suggest that the 1981 farm act may well turn out substantially different from past policy. Historically, farm programs have been directed mainly at enhancing price and income stability in the agricultural sector and increasing the incomes of farm families.

When the 1977 Act was passed, U.S. farmers were still reeling from a dramatic reversal in their incomes. Net farm income had dwindled to $18 billion from its peak of $33 billion in 1973, and there were strong pressures to reinstate government programs to support incomes through higher commodity prices.

The importance of income support today, relative to other farm policy issues, however, has been greatly diminished—although income volatility remains a problem. A key reason is the marked overall improvement in real and relative incomes of the farm population—primarily the result of expanded overseas markets and greater reliance by smaller farmers on nonfarm sources of income. Moreover, government farm income support is now all the more untenable in light of efforts to curb inflation, contain the federal budget deficit, minimize government intrusion in agricultural markets, and in view of the greater concern with keeping U.S. farm prices internationally competitive. In this climate, some version of the Administration's proposal seems likely to survive the legislative process.

Interest Rate Volatility to Continue

The Federal Reserve's discount rate hike last week seems to indicate an increased willingness on its part to respond to what it perceives as excessive money growth. Estimating the precise effect recent Fed actions will have on money market rates in the near term is difficult, however, apart from how the money supply behaves. It is unclear what the Fed's current targets for various measures of reserves are. And even if these targets were known, empirical evidence suggests that any estimate of the federal funds rate consistent with the reserves targets and the new discount rate is subject to considerable error.

Last Monday, the Federal Reserve increased its basic discount rate to a record 14% from 13%. It also raised the penalty surcharge for large banks at the discount window to four from three percentage points.

In a recent Federal Reserve study on the new monetary control procedures, Fed economists noted that the Fed usually "does not alter its nonborrowed reserves target in response to a rise in the discount rate. They note that, as a result, the federal funds rate tends to be bid up over recent levels by roughly the rise in the discount rate. They also present empirical evidence suggesting that a 100-basis point increase in the penalty surcharge has been associated with a slightly smaller rise in the funds rate. Thus, other things equal, the recent discount rate move would be consistent with a rise in the average funds rate of a little less than 200 basis points over the recent weeks' average—or to around 18%.

Other things may not be equal, however. The recent surge in money growth has caused required reserves to grow more rapidly. If the Fed's nonborrowed reserves target has not changed, then the demand for reserves will rise relative to this targeted supply of nonborrowed reserves. If this target is adhered to (which it often is not), the expected result would be a rise in the funds rate relative to the discount rate, and increased discount-window borrowing.

However, the relationships among the volume of discount-window borrowing, the funds rate, the discount rate, and the penalty surcharge are not stable in the near term. In fact, these relationships have become more variable since the implementation of the current reserves-targeting strategy. Fed economists note that the variability in these relationships "adds to the market's difficulty in tracking the Federal Reserve's policy posture" and "contributes to the short-run volatility of interest rates." This, combined with the lack of information the market has regarding the Fed's reserves target, makes it difficult to predict the near-term funds rate even if the behavior of the money supply were known. And given the inherent variability of the money supply and the sensitivity of money-market rates to unexpected money growth, it appears likely that rates will continue to be volatile in the near term.

Africa and Middle East

Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
			6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	12-month changes: consumer prices	12-month changes: latest data	12-month changes: money supply(M1)	exchange rate in U.S. dollars May 6, 1981	change from year earlier May 6, 1981	current monetary conditions	
Africa	**Algeria**	Public-sector spending on telecommunications and infrastructure projects continues to rise.	Jan.	+ 27%	29.0*	$1,525	Mar.	3,503	+ 15%	4.0	0	Agreement reached with Belgium on LNG export price of $4 per million BTUs.	Dec. '79	+ 12%	Oct.	+ 19%	.2425	— 7%	Central bank foreign assets in Sept. up 39% from end-'79.	**Algeria**
	Angola	Lobito port to boost cargo-handling capacity 68%; Benguela Railway still virtually inoperative.	Dec.	+108%	3.6	500	n. a.	—	—	—	—	U.S. and Brazil oil firms step up search; Gulf Oil plans $100-mn. investment.	n. a.	—	—	—	n. a.	—	Foreign-exchange reserves rose sharply last year.	**Angola**
	Botswana	Agricultural output bolstered by above-normal rains, but need for grain imports remains.	Dec.	+ 20%	0.7	850	Mar.	331	+ 20%	8.6	0	Higher imports and stagnant exports suggest wider current-account gap.	Aug.	+ 11%	Jan.	+ 22%	1.40	+10%	Public-sector spending on strong uptrend.	**Botswana**
	Egypt	President announces planned rise in basic subsidies and 25% increase in minimum monthly wage.	Oct.	+ 53%	16.4*	400	Dec.	1,046	+ 98%	3.0	144	Crude export prices cut by between $0.50-$3 per barrel.	Nov.	+ 19%	Nov.	+ 24%	1.45	+ 1%	Growth of bank claims on government slows.	**Egypt**
	Liberia	Business confidence appears to be returning; nationalizations ruled out.	Dec.	— 1%	0.7	380	Feb.	15	— 70%	0.3	58	Rubber export earnings suffer reduced volume and prices.	May '80	+ 16%	Dec.	+ 15%	Par	—	IMF credits bolster foreign reserves.	**Liberia**
	Madagascar	Despite cut in expenditures, 1981 budget projects substantial deficit.	July	+ 39%	2.7	310	May '80	9	— 80%	0.1	50	Imports to be cut 20%; capital outflows temporarily suspended.	Oct.	+ 20%	Dec.	+ 23%	.0042	—12%	Foreign debt service excessively high.	**Madagascar**
	Malawi	Favorable growing conditions could yield positive GDP growth, despite lower development spending.	Dec.	+ 23%	1.5	250	Mar.	48	+ 38%	1.3	59	Early tobacco sales show unexpected price strength.	Jan.	+ 17%	Feb.	+ 7%	1.1650	— 6%	Foreign-exchange shortage continues.	**Malawi**
	Morocco	Real GDP growth officially estimated at 6.3% last year, versus 3.1% in 1979.	Nov.	+ 10%	15.3*	788	Feb.	83	— 80%	0.3	405	Phosphate rock prices averaged $49.50/ton in 1Q 1981, vs. $47 in IVQ 1980.	Nov.	+ 10%	Jan.	+ 6%	.2125	—18%	Arab Monetary Fund to lend $59 million for payments support.	**Morocco**
	Nigeria	Two loans totaling $537 million to cover financing of Ajaokuta Steel Complex signed.	Jan.	+ 30%	61.0	760	Feb.	9,164	+ 47%	9.5	0	Oil price cut possible; output likely to stay at current level.	Mar. '80	+ 12%	Aug.	+ 15%	1.7850	0	Money supply growth to be held to 19% in 1981.	**Nigeria**
	Sierra Leone	IMF approves $200-million loan to support economic program; import and price controls strengthened.	n. a.	—	0.9	262	Feb.	18	— 62%	0.7	22	Higher mining-sector earnings offset by fall in tourist receipts.	Feb.	+ 11%	Dec.	+ 20%	.9925	— 4%	Foreign-exchange shortage severe.	**Sierra Leone**
	South Africa	Consumer prices rising at 18% annual rate, fueled by food price increases.	Feb.	+ 12%	80.2	2,725	Mar.	1,196	+ 84%	0.7	0	First-quarter trade surplus was $742 million, versus $1.7 billion year ago.	Feb.	+ 16%	Jan.	+ 46%	1.2090	— 4%	Larger deficit will boost official claims on capital market.	**South Africa**
	Sudan	Port Sudan-Khartoum fuel pipeline should become fully operational this year.	Aug.	+ 41%	5.8	320	Mar.	34	— 54%	0.3	320	External-account worsening continues; exports average one-third imports.	Dec.	+ 13%	Feb.	+ 39%	2.0175	+ 1%	U.S. aid to rise to $151 million in FY 1981-82.	**Sudan**
	Tunisia	Rising public-sector budget outlays spur continued expansion of economic activity.	Dec.	+ 12%	7.1*	1,135	Mar.	531	— 2%	2.0	0	Trade gap with EEC was $861 million in 1980, versus $572 million in 1979.	Dec.	+ 10%	Jan.	+ 22%	2.1150	—15%	Kuwait Fund lends $40 million for development projects.	**Tunisia**
Middle East	**Iran**	Forecast sharp rise in budget outlays to $44 billion in FY 1981/82; previous fiscal gap put at $11 billion.	Jan.	— 68%	n. a.	—	June '80	15,478	+ 41%	n. a.	0	Oil output averaged 1.4 million bpd in Feb. vs. 1.2 million bpd in Dec.-Jan.	Jan.	+ 25%	Mar.	+ 32%	n. a.	—	Money supply growth accelerating.	**Iran**
	Iraq	State budget estimates put 1981 revenues at $64.8 billion and expenditures at $65.9 billion.	Jan.	— 47%	n. a.	—	n. a.	—	—	—	0	Oil output averaged 700,000 bpd in Feb., up 27% from Jan.	n. a.	—	—	—	3.41	+ 1%	Credit generally available.	**Iraq**
	Kuwait	Official ban imposed on domestic establishment of new investment firms by the private sector.	Jan.	— 3%	23.3**	18,330	Feb.	3,713†	+ 41%	7.1	0	Agreement with BP, Shell, and Gulf on oil supply: lower volume, no premiums.	Dec.	+ 9%	Jan.	+ 12%	3.62	— 2%	Claims on private sector continue to expand.	**Kuwait**
	Saudi Arabia	Actual budget outlays a record $56.2 billion in FY 1979/80, 17.7% greater than allocated.	Jan.	+ 57%	92.0**	16,725	Mar.	29,183†	+ 61%	12.3	0	Price of war-relief crude of 550-600,000 bpd cut to $34 per barrel.	Dec.	+ 2%	Oct.	+ 14%	.2966	— 1%	Saudis agree to lend IMF $9.8 billion over 2 years.	**Saudi Arabia**
	United Arab Emirates	Federal budget outlays for 1981 projected at $6.5 billion, up 60% from 1980 allocation.	Feb.	+ 21%	16.0*	19,275	Mar.	2,329†	+115%	3.3	0	Oil earnings estimated at $18.5 billion last year, up 40% from 1979.	n. a.	—	Jan.	+ 17%	.2735	+ 1%	Bank claims on private sector up 21% in 1980.	**United Arab Emirates**

*1979 **FY 1979/80

†Excluding state reserves

World Interest Rates

market rates of May 6, 1981; bond yields as of May 1, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	17.60	12.00	14.00	9.50	7.50	19.00 penalty rate 22.00	9.00	4.00	6.25
Day-to-Day Money	18.50 May 7	17.50	12.50	13.80	12.25	12.00	19.75	10.25	8.00	7.3125
Treasury Bills 91-day, Middle Rates	16.50	18.00	11.3125	17.00	13.70 one-year	n. a.	17.50 85-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	17.00 finance paper	18.40 finance paper 15% tax w/h	11.26	13.90 Certified	13.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	17.65	18.45 15% tax w/h	12.5625	13.90 Certified	not traded	9.90	21.80	no market	n. a.	no market
Government Bonds Long-term, new and old issues, average yield	14.04	15.75	13.59	11.76 20% tax w/h	14.36	10.05	18.51	11.49	5.48	8.00
Industrial Bonds prime, long-term, new and old issues, average yield	15.05 Aa Industrials	15.625	14.51	18.08	15.39	10.55	19.11	12.29	6.28	7.07
Bank Short-Term Rate to Best Borrowers (prime rate)	19.00	18.50	13.00	19.25	14.35	13.75	22.50 ⅛ quar'ly fee on outstdng.	12.50	8.00	6.75
Bank Time Deposits 3-month	17.875 Cert. of Dep.	17.75	12.375	16.70	13.625	13.45	10.75	12.125 large deposits	9.875 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	19.0625	no market	12.8125	no market	15.00	13.1875	no market	12.00	9.6875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8334	2.1175	.02721	.1878	.4425	.000888	.3988	.4842	.004617
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.75 *P*	7.00 *P*	.50 *P*	4.50 *P*	4.00 *P*	1.00 *D*	7.00 *P*	9.375 *P*	11.00 *P*

Eurodollar Deposits
(London, interbank, bid)
May 7

7-day	**19.25**
1-month	**19.8125**
3-month	**19.75**
6-month	**19.1875**

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	**−7.56**
U.S.-Canada Treasury Bills	**−1.24**
U.S.-Canada Finance Co. Paper	**−1.90**
Eurodollars-U.K. Local Auth. Deposits	**n. a.**

Eurobonds
(average yield on recent straight debt issues)

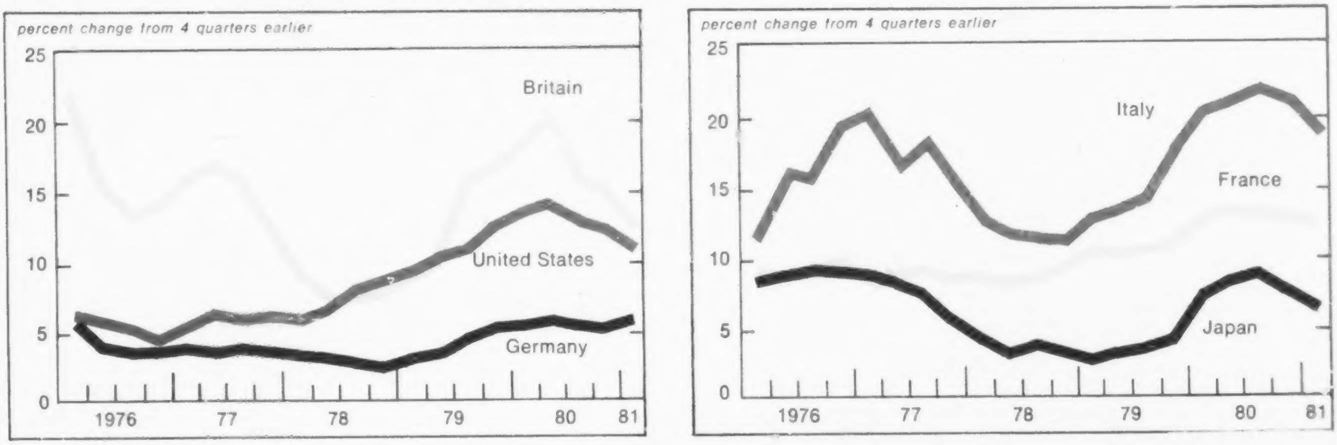
U.S. Dollar Bonds	
7 yrs. and under	**15.625**
Over 7 yrs.	**14.75**
DM Bonds	
7 yrs. and under	**10.75**
Over 7 yrs.	**10.625**

Gold Price
London afternoon fixing

482.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Consumer price trends in major industrial countries



Japanese Economic Outlook

The pace of inflation-adjusted economic growth in Japan slowed to 4.2% last year from 5.6% in 1979, owing largely to the sharp rise in oil prices and a restrictive monetary policy. The forces contributing the most to growth were private plant and equipment investment and net exports; private consumption and residential housing investment were quite weak. The oil price rises contributed to a more-than-doubling of the consumer price inflation rate to 8% and to a widening in the current-account deficit to $10.8 billion from $8.8 billion in 1979.

The domestic economy has remained sluggish so far this year, but economic activity is expected to pick up in the third quarter. For 1981 as a whole, real economic growth of 3.7% is projected. Progress on the inflation front should be substantial, with the rate of consumer price increase likely to ease to 5%. And on the external front, the current-account gap is projected to narrow to less than $6 billion.

A weak economy in 1980

For Japan, as well as for the rest of the non-oil exporting world, 1980 was a year of adjustment to the second wave of huge oil price hikes. The price increases of 1979-80—combined with the restrictive monetary policy aimed at dampening their inflationary impact—slowed Japanese economic activity last year. The major source of weakness was private consumption, as the burden of the terms-of-trade deterioration was borne primarily by labor in the form of moderate wage increases. The annual average wage settlement of 6.9% was outpaced by consumer price inflation, and with little if any increase in real disposable income, consumer spending rose by just 1.3% in real terms. The only bright spots were private plant and equipment investment and net exports. The sharp increase in oil prices induced businesses to undertake investment aimed at energy-saving and rationalization, despite the economic slowdown. Consequently, investment in plant and equipment increased 6.4% in real terms. Net exports, however, provided the main stimulus to growth, contributing 3.6% of the 4.2% real GNP increase.

Japan's rate of inflation, although worrisome early in 1980, moderated significantly over the course of the year, owing to the relatively restrictive monetary policy pursued for much of 1980. On a year-over-year basis, wholesale price inflation peaked at 24% in April and consumer price inflation peaked at 8.7% in September. For the full year, average wholesale prices rose 17.8%, with consumer prices rising 8%. But on a December-to-December basis, the wholesale price index increased only 9.6% while the consumer price index advanced 7.1%.

Although Japan's current-account deficit widened to just under $11 billion last year, the shortfall narrowed as the year progressed and was nearly eliminated by yearend. For the full year, exports rose 25.1% in value terms, while imports advanced 25.3%. The volume of crude oil imports fell 9.5%, but the value of petroleum and petroleum-product imports soared 52%. On trade account, the surplus expanded marginally to $2.1 billion from $1.8 billion in 1979.

The long-term capital account made a remarkable turnaround last year, registering a surplus of $1.8 billion—in contrast to a deficit of $12.6 billion in 1979. The reversal is attributed to a surge in investment from overseas, mainly from the Middle East. The large-scale foreign purchases of Japanese financial assets, together with the steady improvement in the current account, also had the effect of bolstering the yen on foreign-exchange markets last year.

Government policies fine-tuned

As inflation showed signs of easing and as the domestic economic weakness became increasingly apparent in 1980, the Japanese government took steps to spur economic activity, with emphasis on monetary policy. Beginning in August, the central bank discount rate was progressively lowered from its peak of 9% to 7.25% by yearend. Window guidance was also relaxed. Nevertheless, the domestic economy remained surprisingly weak; real GNP advanced at a seasonally adjusted annual rate of only 2% in the final quarter of 1980. As a result, in March 1981 additional measures were taken. The Bank of Japan cut its discount rate to 6.25%, lowered reserve requirements, and, in effect, abolished restrictions on commercial bank lending for the second quarter of 1981. Interest rates on deposits were also cut.

Given the weakness of the domestic economy and the favorable outlook for inflation, a further cut in the discount rate is likely in 1981, and window guidance will probably remain lenient. However, the Bank of Japan, concerned by the prospect of large capital outflows in response to higher interest rates overseas, has left the door open to a tightening of monetary policy should external considerations warrant it.

Modestly stimulative fiscal measures have accompanied the relaxation in monetary policy. Fiscal measures announced in March 1981—which are an extension of those adopted in September 1980—are designed to aid small and medium-sized businesses, boost housing construction, and accelerate public-works spending. But fiscal stimulation has been limited by the government's desire to reduce the budget deficit and thereby cut back on the issue of national bonds for

Japanese Economic Outlook

(continued from page 7)

deficit financing. Indeed, the fiscal 1981 budget calls for the rise in government spending to be held to 9.9%, the lowest rate of increase in 22 years. The budget deficit is set to narrow to 26.2% of total expenditure, with an increase in revenues resulting from fiscal drag and a boost in indirect taxes and in the corporate income-tax rate.

With cumulative government debt soaring, Japan's Prime Minister Suzuki has pledged to reduce the volume of new bond flotations to zero by 1985. Given the reluctance to adopt major new tax measures, this suggests low growth in public expenditure for the next several years.

Capital and exchange controls relaxed

Japan's new Foreign Exchange and Foreign Trade Control Law went into effect on December 1, 1980. Whereas previously all external capital transactions were restricted in principle, under the new law all transactions in trade, foreign exchange, and capital—in principle at least—will be free. Specifically, Japanese residents will be permitted to hold unlimited foreign-currency deposits with domestic banks, nonresidents will generally be allowed to hold shares of domestic companies without restriction, and Japanese lending in yen and dollars will no longer be constrained.

Possible control could still be exerted through administrative guidance, and the monetary authorities have reserved the right to take more direct action in emergencies. Thus, it remains to be seen to what extent the government will act to restrict capital flows in the event of excessive exchange-rate fluctuations or balance-of-payments difficulties. Nonetheless, a new discount mechanism announced as part of the March economic package suggests that the monetary authorities will rely increasingly on interest rates as opposed to direct controls to affect capital flows. The new law is expected to hasten the decontrol of domestic interest rates and promote the alignment of domestic and foreign interest rates through interest arbitrage.

The 1981 outlook: growth rebound in second half

Figures on real growth in the first quarter of 1981 are not yet available, but there is little indication of much improvement in the economy. Housing starts remain extremely low and corporate bankruptcies continue high. And despite severe production cutbacks by manufacturers, inventories remain bloated because of the continued sluggishness of personal consumption and housing. It does appear, however, that the October-March period will prove to have been the low point in the current growth recession.

The government's business-boosting measures are not expected to accelerate the economy's recovery to any great degree. Inventory adjustment will not be completed before midyear, and consumer spending is unlikely to strengthen until after the spring wage increases. Thus, economic activity is not expected to pick up strongly until the third quarter of 1981. For the year as a whole, real GNP appears likely to increase by 3.7%, on a year-over-year basis.

In contrast to 1980, the strength of the economy in 1981 will come from domestic demand. This spring's wage negotiations are expected to result in an average wage settlement of about 7.5%, and as real disposable income rises with a moderation in inflation, consumer spending in real terms should grow about 4%. Despite the increase in corporate tax rates and a deterioration in corporate profits during the first half of the year, business investment in plant and equipment is expected to remain firm.

Government spending on public works and other projects may bolster business during the first part of the year, but for 1981 as a whole, government expenditures will not expand much in real terms. Although imports will be sluggish until economic activity picks up in the second half, net exports will contribute considerably less to growth in 1981 since the pace of export expansion will decelerate with the slump in the world economy and increasing protectionism abroad.

The rate of inflation has continued to moderate during the first few months of this year and is expected to continue doing so through midyear. In the second half, inflationary pressures may heat up in response to a relaxation of monetary policy. For 1981 as a whole, consumer price inflation is forecast to average about 5% on a year-over-year basis—barring an unexpectedly large rise in oil prices.

Finally, the external accounts should show significant improvement this year. The trade surplus is forecast to swell to $8.6 billion, paced by 16% growth in exports and an 11% rise in imports, and the current-account deficit is projected to narrow to $5.9 billion. The improvement on both accounts, however, will prove greater in the first half of 1981, before the domestic recovery has a chance to boost imports. Foreign investment in Japanese stocks and bonds, which slowed toward the end of 1980, accelerated once again in the early part of 1981. And interest is likely to remain high on the part of European and U.S. pension and trust funds as well as such OPEC nations as Saudi Arabia, which recognize Japanese securities as prime candidates for the diversification of their portfolios.

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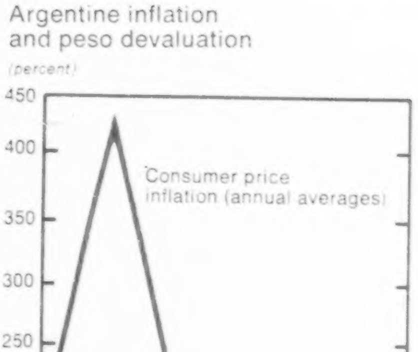
New Exchange Rate Policy for Argentina

Last month's 22.7% devaluation of the Argentine peso in U.S. dollar terms signals a major change in Argentina's exchange-rate policy. The previous policy resulted in a significant appreciation of the peso in terms of its real purchasing power. Although average consumer prices in 1980 were up 100% from 1979, the average peso devaluation in U.S. dollar terms last year was only 28%.

The previous policy resulted in a significant overvaluation of the peso and was used by Argentina's monetary authorities as a means of promoting imports and lowering inflation expectations. It succeeded remarkably well. Imports rose 56% last year, and the annual rate of consumer price inflation dropped to 88% in December 1980 from 140% in December 1979. But the cost of the overvalued peso was considerable. Argentine exporting and import-competing firms suffered financial losses and bankruptcies, and some domestic banks went down with them. Exports increased only 2% last year, the trade balance shifted from surplus to deficit, and reserves fell by $2.7 billion. Interest rates surged from fears of a large devaluation, and overall real GDP grew by only 1.1%.


Argentine inflation and peso devaluation

The Argentine government's new policy is to maintain the real purchasing power of the peso—by adjusting its exchange value in accordance with the differential between domestic and international price rises. The government has left hazy its devaluation targets, indicating that the peso exchange rate will conform with measures to limit the fiscal deficit and the domestic money supply—two major influences on the inflation rate. A leading priority is limiting the central government fiscal deficit, which reached 4.2% of GDP in the first quarter of 1981. To assist the companies hurt by the old exchange-rate policy, the central bank is providing special discount lines through commercial banks. And to limit any resulting money supply increase, the central bank is engaging in open market operations and raising bank reserve requirements.

The shift to a more balanced currency policy promises an improved trade account for Argentina in 1981, in addition to agricultural and industrial gains. International reserves have already begun rising, and the pace of economic growth is expected to increase. Although a competitive exchange rate is not the only element needed to improve Argentina's economic performance, it is most likely to prove to be a critical one.

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New French government policy of reflation will likely entail faster money growth.

The Mitterrand victory will have little impact on the course of the French economy in the short run. A sustained economic recovery is not likely before the latter part of 1981, when the new government moves to reflate the economy. Reflation will be led by consumer spending and will show up in a widened budget deficit. This could lead to an enlarged trade gap and, possibly, higher inflation, depending upon the new administration's monetary stance. Financing the budget deficit will entail either a sharp rise in interest rates, faster money growth, or an increase in borrowing overseas. The new government is unlikely to favor the first of these options and Mitterrand himself opposes the last. But the remaining option of more rapid money growth is inconsistent with Mitterrand's commitment to fixed exchange rates. Thus, an early devaluation of the franc, perhaps in July or August, is highly probable. This could involve a downward adjustment of some 5% in franc intervention limits vis-à-vis the German mark, perhaps as part of a general realignment of EMS parities. In the interim, speculative pressures on the franc will likely be countered with continued high interest rates. Over the long run, continued high inflation will keep the franc under pressure and bring into question its role in the EMS. In the event, moves to tighten capital controls would be possible, an outcome whose anticipation has already produced a widening Euro-domestic interest-rate gap.

Sharply higher Swiss inflation assures continued high interest rates.

Swiss inflation accelerated sharply in the first part of 1981. During the first four months of the year, consumer prices advanced at an annual rate of over 10%. Short-term factors that have boosted prices include a rapid jump in food prices and the weakness of the Swiss franc (particularly in terms of the dollar), which has led to a sharp climb in energy costs. But the more fundamental cause of the resurgence in inflationary pressure is the fast monetary growth that occurred at the end of 1978. On the foreign exchange front, the margin by which Swiss inflation exceeds inflation in Germany is now its widest in six years. This has weakened the franc in recent weeks in terms of the German mark, particularly when the dollar has been firm against both currencies. Incipient franc weakness relative to the mark has been reflected in a narrowing of the Swiss-German interest diffrential. Swiss inflation is set to climb further in the short term, with higher mortgage rates in the pipline. The Swiss central bank is thus expected to retain its restrictive monetary stance, so that interest rates should at least remain at their current high levels.

Turkey's large current-account gap will necessitate financial assistance.

The Turkish current-account deficit is provisionally estimated to have widened to $3.1 billion last year from $1.7 billion in 1979, despite a 26% rise in export earnings. The bulk of the deterioration is attributable to a doubling of the oil import bill to $3.6 billion. For 1981, the Turkish authorities project a current-account deficit of $3.5 billion, with imports expected to climb to $9 billion and exports forecast to reach $3.8 billion. Recent pledges by 17 member-countries of the Organization for Economic Cooperation and Development of $950 million in loans and direct grants will help in financing the projected 1981 current-account gap. But substantial amounts of additional aid and capital inflows will still be needed if Turkey is to finance its current-account shortfall and amortize some $700 million in external debt.

Easing in Brazil's April inflation rate raises hopes of sustained moderation.

Brazil's basic inflation rate—computed from consumer, wholesale, and construction price indexes—fell sharply in April, hinting at the possibility of a sustained decline in the triple-digit rate of price increase. The 5.5% price rise in April compares with a 7.5% average monthly rate for the first three months of 1981 and with a 7% average monthly rate for the last quarter of 1980. The slower pace of inflation suggests that the impact of the government's price decontrol measures for many consumer goods has been absorbed. Also, the government's restrictive fiscal and monetary policies may have begun to bite. Still, despite the dip, the 12-month annualized change in the inflation rate was 120.6% in April, a reminder that Brazil has far to go in its battle on inflation.

A flurry of industrial projects brightens New Zealand growth outlook.

Real GDP growth in New Zealand in fiscal 1980-81 (ended March) is estimated at just 1%. The growth obtained was mainly the result of increased net real exports as real domestic demand actually declined. The outlook for the current and next fiscal years is, however, more promising. Indeed, it is reasonable to expect that the period of stop-go growth around a trend of no increase in real per capita income has ended. This optimism is based on stepped up investment spending on a series of major projects: the Marsden Point oil refinery expansion, aluminum smelter developments, the Taranaki petrochemical projects, and, possibly, the methanol, Mobil methanol-to-gasoline, and Glenbrook steel projects. Still, real economic growth over the next several years is expected to remain moderate, in the 2%-3% range. At the same time, the balance of trade and current account are likely to deteriorate because of the large import requirements associated with these projects and the rise in interest payments incidental to the incursion of new debt. But once the projects become operational later in the decade, New Zealand's external accounts should improve as the output of these various projects is exported or used to reduce imports.

Balance-of-payments improvement for Thailand hinges on higher agricultural productivity.

Stable oil prices have provided some relief to Thailand's hard-pressed balance of payments but it has been largely offset both by higher-than-expected interest rates on debt service and by the sluggishness of exports. In addition, some capital outflow is reported, with domestic investors lured by high rates and relative political stability abroad. Nonetheless, in line with the U.S. dollar, the Thai currency (the baht) has appreciated against the major European currencies—to a level unwarranted by underlying fundamentals. To aid nascent manufacturing firms regain some export competitiveness, the government allowed the baht to depreciate by 1.08% against the dollar in mid-May. Most observers maintain that Thailand's agricultural-commodity-based export sector benefits only marginally from currency depreciation, while a weaker exchange rate adds significantly to inflationary pressures. For this reason, a balance-of-payments turnaround ultimately depends on productivity advances in agriculture. But this will not occur until the government is able to implement long-overdue reforms in pricing policy and in the distribution system.

Nigerian current account to shift into deficit in 1981.

The glut in world oil markets this year has already caused a 10% cutback in Nigerian oil output. This, coupled with weakening oil prices, points to a dramatic near-term deterioration in Nigeria's external accounts. With 1981 export receipts —94% derived from oil sales—forecast at or below last year and imports at least one-third higher, the trade surplus is expected to shrink to about $1.1 billion this year from $8.1 billion in 1980. This will cause the current account to shift to a deficit of $4.4 billion from a $3-billion surplus in 1980. Half of this shortfall is expected to be covered by capital inflows, with the remainder financed by reserve drawdown. In the event, international reserves at yearend would still stand at $8 billion, a comfortable four months' import cover.

Prospects poor for recovery of cocoa prices.

World cocoa prices have declined steadily from their record levels in 1977. Current prices are running $0.78 per pound, compared with an average spot price of $2.03 per pound in 1977. World output for the October 1980-September 1981 season is expected to top the record 1979-80 level of some 1.6 million metric tons, and for the fourth consecutive year, world cocoa stocks will be built up. Stocks as of the start of the 1981-82 season are projected at approximately 700,000 tons—the highest level since 1965-66. Consumption has continued weak because of the growing use of substitutes and extenders and the economic slowdown in the major consuming nations. Meanwhile, the future of a new price-stabilizing International Cocoa Agreement is in doubt as the Ivory Coast and the United States, the world's largest producing and consuming countries, have refused to join. Cocoa prices are thus likely to remain near their present levels—or head even lower—constrained by the steady inventory accumulation of the last few years.

Consumer Bearishness Constraining Recovery

The surprisingly large revision in first-quarter GNP growth is prompting many economists to take a second look at their forecasts. The U.S. Department of Commerce announced last week that real growth in the first three months of the year occurred at an annual rate of 8.4% instead of the 6.5% rate reported earlier, indicating an economy substantially more buoyant than had been previously thought.

These new numbers, juxtaposed with other signs of strength in the economy, raise doubts that the second- and third-quarter growth setback projected in earlier forecasts will come to pass. Exports, which have been a consistent source of strength over an otherwise sluggish period, are expected to hold their own even though the economies of most of the United States' European trading partners appear likely to remain in the doldrums. Furthermore, there are indications that the U.S. economy is beginning to adjust to the higher levels of interest rates that have had such a crippling effect on certain sectors. Business investment—which is usually quite sensitive to interest rates—is now at a relatively healthy level and seems likely to stay that way. And while the housing sector still has some distance to go in its recovery, construction activity has picked up from year-ago levels, despite higher mortgage rates.

But for those economists still somewhat hesitant to abandon past predictions, there is also ample evidence that the spring and summer months could show little if any growth. The consumer sector, which accounts for two-thirds of GNP, remains listless. Retail sales of nondurable goods around Easter were reasonably brisk, but beyond that, financially strapped consumers have been pulling back on spending. Adjustment for inflation reveals that personal consumption expenditures have not increased since January. Mortgage delinquencies reportedly are up, and personal saving, despite a modest improvement to 5% of disposable income last month, is still quite low by historical standards. Personal income rose only 0.6% in April—the smallest percentage increase since last spring. And the weak housing market has put a considerable damper on homeowners' ability to cash in on capital gains as a source of additional funds. Consumers have been somewhat reluctant to turn to credit buying as well, as net extensions of consumer credit have continued to decline relative to income.

Without help from the dominant consumer sector, the economy could experience relative weakness, at least until fall when the expected implemention of a tax cut bolsters spending. Thus, the current weakness is likely to represent only a pause in the general cyclical recovery and expansion that has been taking place since the middle of last year.

Money Surprises and Interest Rates

Many observers have been puzzled by the heightened volatility of interest rates—often in unexpected directions—in response to announcements of money growth data. Take for example, the financial markets' reaction to M1-B growth for the week ending May 6. The markets had been anticipating an unusually large increase in the money stock (M1-B) for that week, based to a large extent on the tendency of M1-B to jump sharply in statement weeks ending on the sixth of each month. This tendency is attributed in part to the early disbursement of social security payments when the normal disbursement day falls on a Sunday. It is widely believed that the Federal Reserve's seasonal adjustment procedure does not adequately compensate for this "sixth day" effect.

When the Federal Reserve announced on May 15 that the increase in M1-B for the week ending May 6 was a sizable $3.1 billion, market interest rates *declined* sharply. This behavior may at first glance appear paradoxical. It contrasts with the abrupt *rise* in market interest rates following the announced $4.2-billion increase for the week ending April 22. And both the May 6 and April 22 increases in M1-B were obviously substantial—in the past 1½ years, on only eight occasions were the weekly increases larger.

To a great degree, the resolution to this apparent paradox lies not in the size of the *actual* increase in M1-B, but in the rise relative to the market's *expectation* of what the increase was going to be, which produces "announcement effects" in financial markets each Friday afternoon. Thus, it is chiefly when financial markets are surprised by the weekly behavior of the money supply that pronounced changes of interest rates occur. In fact, interest rates respond in a fairly consistent manner to the *unexpected* changes in the money supply, or to "monetary surprises". Evidence suggests that a smaller-than-expected increase in the money supply generally causes interest rates to fall, while a larger-than-expected climb causes them to rise.

When surprised by the behavior of the monetary aggregates, financial market participants reevaluate not only prior expectations of Federal Reserve policy, but expectations of the strength in money demand. For example, a large unanticipated increase in the money supply may lead to an upward revision in the markets' anticipation of total spending, and thus reflect unanticipated strength in money demand.

The increased emphasis of the Federal Reserve on controlling money growth has, of course, increased market attentiveness to money-stock changes. Thus, despite the imprecision of the weekly numbers, short-run money "surprises" are likely to continue, producing interest rate volatility on Friday afternoons for the foreseeable future.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				central bank rate	exchange rate in U.S. dollars		
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	May 20, 1981		current monetary conditions	
Austria	Industrial production stagnating as unemployment begins to rise; no output growth expected this year.	Oct.	+3%	76.3	+3.6%	Mar.	4,459	+18%	2.3	0	German recession dimming export prospects.	Feb.	+7%	Feb.	+13%	6.75%	.0625	Credit moderately tight.	**Austria**
Belgium	Industrial production was up in February, but leading indicators continue to show weakening.	Feb.	−13%	118.9	+1.5%	Mar.	6,064	+48%	1.1	0	European recession and overvalued franc hurting exports.	Apr.	+7%	Dec.	+2%	14.00%	.0269	Interest rates ease as pressure on franc moderates.	**Belgium**
Britain	First signs of end to recession just beginning to appear.	Mar.	−9%	515.3	−1.4%	Mar.	20,885	+5%	2.3	614	Current account continues to post massive surplus.	Mar.	+13%	Feb.	+10%	12.00%	2.0910	Prospects for further interest-rate reductions dimming.	**Britain**
Denmark	Economy remains in deep recession.	Jan.	−3%	67.1	−1.0%	Mar.	3,051	+66%	2.0	0	Trade deficit continues unremittingly large.	Feb.	+11%	Nov.	+7%	11.00%	.1418	EMS membership forces high rates in line with Germany.	**Denmark**
Finland	Economy continues to grow, but inflationary pressures mount.	Jan.	0	51.0	+6.0%	Mar.	1,779	+6%	1.4	82	Trade balance remains in healthy surplus.	Mar.	+13%	Nov.	+5%	9.25%	.2315	Monetary policy remains restrictive.	**Finland**
France	New administration plans to reflate economy.	Mar.	−8%	651.1	+1.8%	Mar.	30,107	+43%	2.7	0	Consumer boom may widen trade gap in late 1981.	Mar.	+13%	Nov.	+10%	9.50%	.1811	Interest rates high to protect franc.	**France**
Germany	Industrial production drops in March after rises in January and February; domestic orders weak.	Mar.	−5%	827.7	+1.8%	Mar.	50,071	+8%	3.4	0	Sharp rise in foreign orders points to narrowing of current-account gap.	Apr.	+6%	Feb.	+4%	7.50%	.4369	Fall in rates unlikely until U.S. rates decline.	**Germany**
Greece	Reflationary investment budget in place in advance of November elections.	Sept.	+1%	41.0	+0.6%	Feb.	1,009	+12%	1.2	85	Oil bill officially expected to rise to $3.6 billion in 1981.	Feb.	+26%	Nov.	+19%	20.50%	.0180	Credit eases somewhat.	**Greece**
Ireland	Industrial production continues depressed, but there are signs of small upturn.	Nov.	−6%	17.6	+1.9%	Mar.	2,518	+24%	2.8	0	Exports reasonably strong, but heavy imports will yield large payments gap.	Nov.	+18%	Feb.	+18%	12.75%	1.6050	Budget gap, unease about possible elections keep rates high.	**Ireland**
Italy	Sharp rise in industrial production in February unlikely to be sustained.	Mar.	−4%	392.8	+4.0%	Mar.	17,973	−6%	2.2	0	Lira devalued 6% vs. DM to prevent further drop in competitiveness.	Apr.	+20%	Nov.	+11%	19.00%	.0008757	Pressure on lira eases after devaluation.	**Italy**
Netherlands	Government introduces further spending cuts despite weakening economy.	Mar.	−7%	160.8	+1.2%	Mar.	10,965	+29%	1.8	0	Exports hurt by European recession, but higher gas prices limit payments gap.	Apr.	+6%	Jan.	+7%	9.00%	.3930	Interest rates ease; guilder remains strong in EMS.	**Netherlands**
Norway	Despite buoyant oil sector, real GDP growth in 1981 unlikely to reach 1%.	Feb.	−4%	56.7	+3.5%	Mar.	5,255	+18%	3.8	0	Payments balance remains strong, but exports threatened by high prices.	Mar.	+14%	Jan.	+12%	9.00%	.1777	Inflation building, forcing continued tight money policy.	**Norway**
Portugal	World recession likely to hamper strong economic growth.	June	+7%	24.1	+3.9%	Feb.	552	−20%	0.8	106	Widening of current-account deficit to $1.6 billion forecast for 1981.	Jan.	+16%	Nov.	+24%	18.00%	.0164	Monetary growth still rapid.	**Portugal**
Spain	Likelihood of poor agricultural crop clouds domestic economic outlook further.	n. a.	—	208.5	+0.5%	Jan.	11,566	−14%	4.0	237	Prospects for 1981 poor, but weaker peseta enhances competitiveness.	Jan.	+14%	Dec.	+14%	8.00%	.0110	M3 growth eased to 15.6% in February.	**Spain**
Sweden	Real GDP growth remains sluggish.	Jan.	−3%	124.3	+2.3%	Mar.	4,138	+23%	1.6	0	Current-account gap expected to remain in kr. 12-billion range.	Feb.	+13%	n. a.	—	12.00%	.2057	No change in central bank's tight monetary stance.	**Sweden**
Switzerland	Economic downturn likely after midyear.	Dec.	+1%	99.8	+2.4%	Mar.	12,884	−4%	4.6	0	Trade deficit of $1 billion posted in first quarter.	Apr.	+6%	Jan.	−3%	5.00%	.4920	Monetary policy remains tight.	**Switzerland**
Canada	Gains in paper, metal, and electrical-product output give strong boost to manufacturing output rate.	Feb.	+1%	246.5	+0.1%	Mar.	2,816	+4%	0.5	0	Reserves decline as $300-million IMF standby credit is repaid.	Apr.	+13%	Feb.	+6%	18.71%	.8327	Money supply targets lowered to 4%-8%.	**Canada**
United States	Economy in 1981: fast start, slower now, pick-up by late summer.	Apr.	+3%	2,627.0	−0.1%	Mar.	19,256	+87%	0.9	0	Current account for 1981 likely to be in rough balance.	Mar.	+11%	Apr.	+2%	14.00%	—	Strong short-term credit demands sustain high rates.	**United States**

World Interest Rates

market rates of May 20, 1981; bond yields as of May 15, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	18.98	12.00	14.00	9.50	7.50	19.00 penalty rate 22.00	9.00	5.00	6.25
Day-to-Day Money	20.00 May 21	19.50	11.00	12.10	17.50	11.80	19.75	10.25	0.50	7.4375
Treasury Bills 91-day, Middle Rates	16.61	18.80	11.375	17.00	n. a.	n. a	18.40 99-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	17.95 finance paper	19.10 finance paper 15% tax w/h	10.91	13.90 Certified	17.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	17.75	19.10 15% tax w/h	11.5625	13.90 Certified	not traded	9.90	21.10	no market	n. a.	no market
Government Bonds Long-term, new and old issues, average yield	13.56	15.60	14.03	10.21 20% tax w/h	15.94	10.41	18.64	11.94	5.85	8.34
Industrial Bonds prime, long-term, new and old issues, average yield	14.60 Aa Industrials	16.25	14.93	15.11	17.13	10.91	19.41	12.91	6.23	7.10
Bank Short-Term Rate to Best Borrowers (prime rate)	20.00	19.50	13.00	18.75	14.35	14.25	22.50 ⅛ quar ly fee on outstdng.	13.00	8.00	6.75
Bank Time Deposits 3-month	17.50 Cert. of Dep	18.75	12.1875	16.75	17.375	13.20	10.75	11.75 large deposits	9.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	18.375	no market	12.3125	no market	19.75	12.875	no market	11.75	9.6875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8327	2.0910	.0269	.1811	.4369	.000876	.3925	.4900	.00454
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.375 *P*	6.50 *P*	8.50 *P*	2.25 *D*	5.50 *P*	2.75 *D*	6.25 *P*	8.75 *P*	11.00 *P*

Eurodollar Deposits

(London, interbank, bid)
May 21

7-day	19.0625
1-month	20.4375
3-month	19.25
6-month	18.3125

International Arbitrage

(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.11
U.S.-Canada Treasury Bills	−1.48
U.S.-Canada Finance Co. Paper	−1.312
Eurodollars-U.K. Local Auth. Deposits	− .25

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.75*
Over 7 yrs.	15.25*
DM Bonds	
7 yrs. and under	11.375*
Over 7 yrs.	10.125*

Gold Price

London
afternoon fixing

479.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Bond yields as of May 13, 1981.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	10.6 (Mar.)	12.6 (Apr.)	12.6 (Mar.)	12.5 (Mar.)	5.6 (Apr.)	19.9 (Apr.)	5.6 (Apr.)	6.2 (Mar.)
Industrial production*	3.0 (Apr.)	0.5 (Feb.)	−9.2 (Mar.)	−8.0 (Mar.)	−5.3 (Mar.)	−4.1 (Mar.)	1.0 (Dec.)	1.7 (Mar.)
Trade balance† *(billions of local currency units)*	−$0.45 (Mar.)	C$0.51 (Mar.)	£0.31 (Feb.)	−FF1.93 (Apr.)	−DM0.14 (Mar.)	−Lit.1,530 (Feb.)	−SF0.71 (Apr.)	¥323 (Apr.)
Money supply (M1)*	1.6 (Apr.)	6.4 (Feb.)	10.0 (Feb.)	10.0 (Nov.)	4.3 (Feb.)	11.5 (Nov.)	−3.0 (Jan.)	−2.4 (Jan.)
Velocity of money (M1)*	4.6 (Dec.)	−0.14 (Dec.)	11.4 (Sept.)	n. a.	0.6 (Dec.)	6.6 (Sept.)	n. a.	12.6 (Sept.)
Reserves minus gold *($ million, change from previous month)*	730 (Mar.)	372 (Mar.)	138 (Mar.)	472 (Mar.)	3.244 (Mar.)	2.652 (Mar.)	1.156 (Mar.)	333 (Mar.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Philippine Economic Weakness Continues

The pace of real economic growth in the Philippines fell short of official targets last year, dropping to 4.7% from 5.8% in 1979. The combination of sharply higher oil import prices and depressed world prices for key commodity exports played havoc with the Philippines' balance of payments and increased external indebtedness dramatically. A double-digit inflation rate compounded the economic difficulties, which together forced the pursuit of moderately restrictive monetary and fiscal policy.

The outlook for 1981 is not much more promising. The domestic economy is expected to continue in low gear, with real GNP projected to rise only marginally. Still, the balance-of-payments deficit is expected to widen and spur a further increase in external debt. Financial assistance from the International Monetary Fund and the World Bank, however, will preclude any deficit-financing problems.

A close-up view of the economy in 1980

The weakness that characterized the Philippine economy last year was the result of three basic influences: sharply higher oil prices, which boosted the 1980 oil import bill to $2.2 billion from $1.4 billion in 1979, despite a small drop in import volume; disastrously low export prices for copra and coconut oil, which cut into cash incomes throughout the Philippines; and the restrictiveness of domestic monetary and fiscal policy, which was aimed at reducing inflation and the external-payments deficit and which was also in compliance with the terms of a two-year standby agreement with the IMF.

The 4.7% growth in 1980 was led by an expansion of mining production, which posted 9.2% growth last year—stimulated by high prices for gold and copper and fast growth of the utilities. An advance of 6.8% in farming, fishing, and forestry also helped. But the pace of manufacturing growth declined slightly, owing to weakness in the consumer-oriented industries. And the performance of the construction and transportation sectors was also down.

Despite the domestic sluggishness, consumer prices rose at a 17.8% year-over-year rate in 1980, after an 18.8% rate of price rise in 1979. A contributing influence was the government's policy of passing higher crude import prices through to consumers.

The restrictive monetary policy last year held the rate of money supply (M2) growth to just under 18%. With an inflation rate of roughly the same magnitude, liquidity was squeezed, and a fairly large number of firms fell into financial difficulty. This triggered credit assistance to firms and was in turn followed by the Philippine central bank's approval of new interest-rate regulations. Effective July 1, 1981, ceilings will be lifted from time deposits and from debt with terms of more than two years. Debt of less than two years' maturity will continue subject to ceilings, but even these appear provisional. These measures reveal a desire to maintain relatively high interest rates to minimize speculation and bolster savings in the face of high inflation, and to encourage longer-term lending by the commercial banks. They complement the terms of the 1980-81 IMF standby agreement, which calls for ceilings on domestic credit growth and on other financial variables, as well as ceilings on external loan commitments. And they have been accompanied by other financial-sector reforms aimed at increasing financial institutions' flexibility and efficiency.

The Philippine external accounts suffered badly last year. The trade deficit widened to $2.1 billion from $1.5 billion in 1979, and with a deterioration in net services earnings—owing largely to higher interest payments on external debt—the current-account gap expanded to $2.4 billion from $1.6 billion a year earlier. The major cause of the worsening was the higher cost of 74 million barrels of imported oil. Indeed, the $2.2-billion 1980 oil import bill could have been far higher were it not for the 1.6% drop in import volume. On the plus side, strong sugar export earnings compensated for depressed coconut oil receipts, and manufactured exports—which now account for almost one-third of total exports—increased by 34%.

ECONOMIC INDICATORS

	1977	1978	1979	1980 est.
Real GNP Growth, %	5.7	6.3	5.8	4.7
Consumer Price Rise, %	7.9	7.6	18.8	17.8
Current-Account Balance (million dollars)	-827	-1,274	-1,561	-2,400
External Debt, Long-Term (million dollars)	5,554	6,838	9,778	12,270

The expanded current-account gap resulted in a net addition to external debt last year of $2.5 billion, and the Philippine debt-service ratio reached 18.7%. The 1980-81 IMF standby eased the deficit funding by providing $338 million, over and above $1.2 billion in other medium- and long-term loans. In addition, the World Bank extended a $200-million program loan.

The current outlook

The domestic economy is not expected to experience any significant rebound this year. Commodity prices remain weak, government policy continues restrictive, and high oil prices are still taking their toll. Overall,

Philippine Economic Weakness Continues

(continued from page 7)

inflation-adjusted economic growth of about 5.8% is officially forecast. Externally, the current-account deficit for 1981 is expected to expand slightly—perhaps to about $2.7 billion. Again, the cost of imported oil will continue to be the chief contributor to the sustained external-account deterioration. The 1981 oil bill is forecast at $2.7 billion.

Prospects for domestic oil output offer little relief. Domestic oil production has dwindled to a mere 4,000 barrels per day, and although two new oil fields are scheduled to come on stream later this year, their combined output is projected at only 60,000 barrels per day. All told, the Philippines' domestic oil reserves are not ever likely to be able to satisfy more than 15%-20% of domestic oil needs. The government's publicized energy program, however, does hold some promise of reducing the role of imported oil in total domestic energy consumption to 50% from 90%. The program is aimed at maximizing the utilization of domestic energy sources of coal, hydroelectric, and geothermal power.

Funding of the 1981 external deficit will once again be aided by the IMF and the World Bank. The IMF standby will provide $195 million and a second World Bank program loan of $200 million is expected. Furthermore, the IMF's ceiling on 1-12-year borrowings has been raised to $2.05 billion, including $350 million in added financing for a nuclear power plant. The Philippines' total debt-service ratio in 1981 is not expected to rise from its 1980 level. Indeed, despite its rapidly rising debt-servicing costs, the Philippines' debt-service ratio is expected to remain moderate through 1983. Still, the size and growth of external debt and its service render the Philippines vulnerable to the vicissitudes of its external terms of trade.

Fundamental weaknesses in the economy

While the pace of economic growth in the Philippines in the 1969-79 period averaged 6.1% per annum, well above the 1980 and current growth rate, even this performance was poorer than that of most other East Asian countries over the same 10-year period. Thailand's annual average real GDP growth rate between 1969 and 1979 was 7.7% and Indonesia's was 7.5%.

The reasons for the Philippines' history of relatively slow growth have much to do with the country's physical characteristics, rather than with faulty economic management. The Philippines is essentially a collection of some 7,000 islands, of which 880 are inhabited and largely mountainous. There is also no common language. Thus, transport and communications problems are enormous. In addition, the combination of an insufficient supply of arable land and a relatively large population, whose annual growth rate is now about 2.4%, has necessitated the import of growing quantities of food—despite significant progress in boosting agricultural output. Finally, the prices of the Philippines' exportable commodities are not only volatile in world markets, but they have suffered a long-term decline relative to imports. To be sure, the secular deterioration in terms of trade has accelerated since the oil price explosion of 1973, but it actually began well before then. The decline has reduced the real earning power of Philippine exports by more than 60% in the last 30 years.

Perhaps the Philippines' greatest assets, however, are its human resources. The country's motivated and capable work force is rich with managerial as well as ordinary labor talent and is far from fully employed. Thus, an important potential stimulus to further economic development is improved utilization of local manpower. The rapid growth in recent years of labor-intensive manufacturing for export points the way.

Political uncertainty clouds near-term outlook

In contrast to the relatively lackluster economic climate, the political situation has been turbulent. A chain of events was set in motion after President Ferdinand Marcos announced an end to martial law on January 17. The move was followed by a plebiscite to replace the parliamentary form of government with a strong presidential system—which won approval on April 7. The focus is now on June 16, when presidential elections are scheduled. President Marcos is projected to win reelection, which will continue his political leadership for another six years. Nonetheless, there is opposition to Marcos' rule, and several groups appear to be testing the limits of liberalization in the wake of the lifting of martial law. Labor, for one, is stirring, and several strikes have already been called. The Philippines' actual economic performance in 1981 is thus subject to the course of political, as well as economic events, whose outcome is still unknown. Yet the Philippines' sound economic management offers the hope of stable, if not rapid, economic growth in 1981 and beyond.

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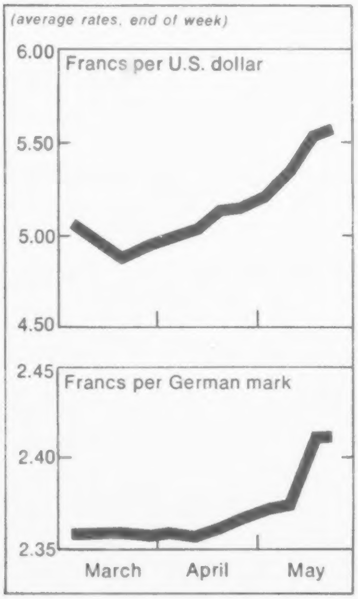
The Economic Implications Of France Under Mitterrand

The election of French President Francois Mitterrand breaks with 23 years of conservative rule during the Fifth Republic. Clearly, the outcome will have a major impact on the course of economic development in France, although the full implications may not be clarified until the National Assembly elections are concluded. Mitterrand was elected on the basis of a comprehensive economic program that includes: reflation, extensive nationalization, increased minimum wages and social welfare payments, overhaul of the tax system, and a shorter working week. The overall aim is to boost economic growth to 3% per annum in real terms. Mitterrand's program reverses the policy of recent years under the "Barre Plan," bringing back to the fore Keynesian demand-management techniques as a means of restoring full employment. It also contrasts with the restrictive policies pursued by nearly all other Western industrial nations.

Movements in the franc exchange rate



In the short run, the Mitterrand victory is likely to have little impact on the course of the economy. However, the first part of Mitterrand's program —higher minimum wages and family allowances—has already taken effect. These measures were not contingent on the results of the National Assembly elections and will boost economic growth in the second half of the year. Over the longer run, reflation will take the form of a consumer boom and show up in a widening budget deficit. This will enlarge the French current-account deficit and may lead to higher inflation, depending on the monetary stance of the new administration.

Fear of reflation has undermined confidence in the franc, which has been trading consistently at its floor within the European Monetary System in terms of the German mark. The spectre of devaluation has prompted a sharp rise in short-term interest rates to quell speculation. The discount rate on Treasury bills (the official intervention rate) has been raised to a record 22%, and call—or day-to-day—money now stands at 20%, also a record. A tightening of exchange controls on "leads" and "lags" in trade payments was also announced to supplement higher interest rates.

Should dollar strength prompt a renewed tightening of monetary policy in Germany, a temporary tactical withdrawal of the franc from the EMS may be deemed necessary. In any event, a downward adjustment in franc intervention limits vis-à-vis the mark, as part of a general realignment in EMS parities, is likely following the National Assembly elections. In the interim, speculation will be countered with continued high interest rates, and, possibly, a further tightening of existing capital controls.

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Further adjustment to higher oil prices needed in Sweden.

Recent political problems have delayed Sweden's adjustment to high energy prices. The policies introduced several months ago, however, have given the authorities some reprieve. They have reduced domestic demand generally, and the resultant falls in consumption and industrial output have helped reduce consumption of oil. Crude oil imports are down 18% from last year, which has given Sweden a $26-million trade surplus for 1981 to date, compared with a deficit of $54 million for the same period in 1980. The government has revised its forecast for the 1981 current-account deficit down to 19.6 billion kronor ($3.9 billion, at current exchange rates) from kr. 22.8 billion ($4.6 billion), and the authorities now expect to borrow the equivalent of 20 billion kronor from abroad, versus the kr. 25 billion originally planned on. Further adjustment, however, is still needed. The improved trade balance owes more to reduced imports than to a favorable export trend; indeed, exports are still 5% lower than a year ago. In addition, the high rate of inflation and its impact on indexed earnings remain far too high for comfort.

Norway's oil boom a mixed blessing.

Norway's booming oil sector continues to pose problems for the domestic economy. Large wage increases in the oil sector have spilled over to other labor-market sectors. And after reaching 13.7% at the end of 1980, the rate of inflation has climbed further, pushing the April price index 14.6% above its year-earlier level. Price and cost increases have hurt competitiveness in the traditional industries, and the government is under pressure to provide heavy subsidies to keep unemployment down to its present level of just below 1.5%. The benefits of Norway's oil boom are, of course, most evident in the external sector. Oil export earnings contributed to a $33-million trade surplus in April, bringing this year's cumulative surplus to $85 million, compared with $1 billion for the year-earlier period.

Finnish GDP growth slowdown forecast, but pace will stay one of highest in the West.

The worldwide recession is beginning to impinge on Finland's economic performance. Higher-cost oil imports, a weakening export showing, and increased debt service have widened the Finnish current-account deficit, which is projected to rise to $1.7 billion this year from $1.3 billion in 1980. Partly as a result of the export slowdown, 1981 real GDP growth of only 2.5% is forecast by the OECD, compared with growth of nearly 5% in 1980. Inflationary pressures, however, have been strong for some time, and consumer prices are likely to rise by 12% this year. Nonetheless, the overall picture is far from gloomy. Finnish economic growth this year will remain among the fastest in the West—for the third year in succession. And as time passes, the economic slowdown will have a beneficial effect on inflation and on the balance of payments. The OECD currently forecasts both a drop in the inflation rate to 9.75% in 1982 and a narrowing of the current-account deficit to $1.1 billion.

Indian GNP growth rebound accompanied by widening external-account deficit.

India's inflation-adjusted GNP advanced by an estimated 6.5% in fiscal 1980-81 (ended March 31), after contracting by 4.5% in fiscal 1979-80. Foodgrain production rebounded to a record 133 million tons from 109 million tons in 1979-80, and overall agricultural output rose 19%, the result of a favorable monsoon. At the same time, industrial output expanded by an estimated 4% as the number of man-days lost because of strikes dropped dramatically and as the increased rainfall helped ease infrastructural bottlenecks. For the year as a whole, the rate of inflation was little changed, with wholesale prices on average up a provisional 17.9% in 1980-81, as against a rise of 17.1% in 1979-80. (On a March-to-March basis, the wholesale price increase was 16.4%, compared with 21.4% in 1979-80.) On the external front, a jump in the oil-import bill to $7 billion pushed the trade deficit to an estimated $6.5 billion in 1980-81 from $3.5 billion in 1979-80. The current-account gap widened to approximately $3.5 billion. Despite the receipt of more than $1 billion in funds from the IMF, India's reserves (less gold) dropped to $6.9 billion at yearend 1980, some $500 million below their year-earlier level.

Prospects brighten for Costa Rica's external accounts.

Cost Rica is beginning to reverse the deterioration in its international payments that has proceeded steadily for three years. The country's current-account deficit in fiscal 1979-80 was equivalent to 14% of GDP, compared with 9% of GDP in 1977-78, and gross international reserves totaled only $110 million at the end of February, sufficient to cover just one month's imports. The external-account worsening was principally the result of expansionary fiscal policy and deteriorating terms of trade. The implementation of several measures late last year—including a large devaluation and the imposition of prior import deposits and surcharges—has had some impact. In the first quarter of this year, imports were down 16% from first-quarter 1980, which reduced the trade deficit to $91 million from $118 million last year. Further improvement is possible if the authorities adhere to a new stabilization program within the context of a $300-million IMF extended-facility arrangement.

Latin American nations cooperate on energy.

In an effort to ease the oil import bills and spur energy resource development elsewhere in Latin America, Mexico and Venezuela are currently exporting oil at preferential financial terms to a number of Central American and Caribbean nations. The beneficiaries thus far include Costa Rica, Nicaragua, the Dominican Republic, El Salvador, Panama, Guatemala, Haiti, Belize, and the Bahamas. Each of these countries may purchase 70% of its oil at the prevailing international price, with the remaining 30% taking the form of a five-year loan at a 4% annual interest rate. If the importing country invests this sum in the development of energy resources, the Mexican and Venezuelan governments will lend the outstanding amount out for 20 years at a 2% annual interest rate. For those countries highly dependent on imported petroleum, the balance-of-payments relief can be significant.

North Yemeni economy underpinned by remittances and foreign aid.

The Yemen Arab Republic (North Yemen) is the poorest country in the Arab world, but it has until only recently experienced strong economic growth. Its domestic productive base is dominated by subsistence agriculture, yet incomes have been buoyant because of an average $1.3 billion a year in remittances from one million North Yemenis living in Saudi Arabia and generous Arab aid. The economy experienced a boom between 1976 and 1978, but its external accounts remained in surplus and foreign-exchange reserves were built up to $1.6 billion. More recently, the boom conditions have subsided, with workers' remittances first easing and then declining in 1980. The government has made a concentrated effort to fight poverty by rapidly increasing development spending, and progress has been satisfactory. But the public budget is now in deficit and economic conditions are sluggish. Nonetheless, the economy is underpinned by more than $1 billion in foreign-exchange reserves (seven months' import cover), low external debt, and continued high aid commitments.

The prospect of a large coffee crop weakens prices further.

The world coffee market is characterized by continued sluggishness of demand and plentiful supplies. The crop for the 1980-81 season is projected at 81 million bags, about the same as last season, with total available exports estimated at 60.5 million bags. But the 1981-82 Brazilian crop—whose harvest has already begun—is estimated at 32 million bags, 50% higher than the previous year's crop. Coffee consumption worldwide has grown more slowly than output, and consumption in the United States, the world's largest consuming nation, is no higher today than it was in 1950. The prospect of a large rise in supplies in the face of relatively flat demand has reduced prices to $1.10 a pound, compared with a 1980 peak of $2.02 and a record of $3.40 a pound in 1977. A new international coffee pact, adhered to by 44 exporting countries and 25 importing countries, seeks to keep prices above a minimum of $1.15 per pound by setting export quotas for producers. Exports to pact members were initially limited to 57.4 million bags, but the quota was lowered to 55 million bags as prices fell to their current levels. Despite the coffee agreement's efforts, prices could drop further in the months ahead.

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Budget Outlook Improves

Recent figures on the federal budget have been encouraging. In both of the last two months, the budget has either been in balance or in surplus, on a seasonally adjusted basis. While such favorable results are unlikely to persist, they do suggest that the prospects for a substantially larger fiscal 1981 deficit than that targeted by the Reagan administration—an outcome that seemed probable just a few months ago—have diminished.

The U.S. Treasury recently reported that the budget surplus in April was $17.3 billion. While receipts generally exceed expenditures in April because of the April 15 tax deadline, the monthly surplus still compares favorably with last April's surplus of $9.9 billion and the April 1979 surplus of $11.5 billion. In March, the Treasury reported a monthly deficit of $9.6 billion. But this also compares favorably with last March's deficit of $13.2 billion and the March 1979 deficit of $12.6 billion.

When adjusted for seasonal variation, the 1981 budget figures for March and April actually represent small surpluses. This is in marked contrast to the behavior of the budget figures in the earlier months of the fiscal year, during which the budget was in deficit at an average seasonally adjusted annual rate of more than $80 billion. The seasonally adjusted average for fiscal 1981 through April is now a little less than $60 billion.

These recent figures have led a number of forecasters to revise downward substantially their forecasts of the fiscal 1981 deficit. Most forecasts currently call for a shortfall of only a little more than $60 billion—or moderately above the Reagan administration's current target of $58 billion—compared with consensus forecasts of over $70 billion (and some forecasts of more than $90 billion) just two months ago. Given the relatively strong pattern of federal receipts in May, the May budget figure will probably be consistent with these new estimates.

Most of the recent improvement in the budget deficit is the result of higher-than-expected receipts, rather than lower-than-expected expenditures. This in turn is due at least in part to the faster-than-expected economic growth experienced so far this year. As economic forecasts, then, budget-deficit forecasts can be highly precarious, and are thus subject to sizable revisions even in the short run.

It does appear likely however, that the deficit this fiscal year will be in the $60-$65 billion range. Of course, this is still quite large—and somewhat higher than last year's deficit of $59 billion. Nonetheless, the recent improvement in the budget outlook should be viewed somewhat favorably by the markets in the near term.

Housing Finance Adapting to Change

The thrift industry has come under severe stress over the past three years as interest-rate ceilings have been gradually removed and monetary policy has grown more restrictive. The average return on thrift institution portfolios of long-term assets changed only slowly as new mortgages were written, while the cost of funding these portfolios with short-term deposits soared. Under pressure from the financially troubled industry, the Federal Home Loan Bank Board has issued sweeping new regulations that liberalize the terms under which mutual savings banks and savings and loan associations may issue variable-rate mortgages. Such adjustable-mortgage loans may lighten the burden on the thrift industry, but they may also weaken overall demand for mortgages and keep the housing market in the doldrums.

Under the new regulations, thrift institutions may issue mortgages that have no limit as to the timing or magnitude of interest-rate movements over the life of the mortgage. The rate changes, however, must be tied to some easily verifiable interest rate, such as a specified-maturity Treasury security. Previously, thrifts could adjust the interest rate by one-half of a percentage point, at most, every six months and by 2½ percentage points over the life of the mortgage loan. The lender also has the option of extending the maturity of the loan or increasing the amount of unpaid principal ("negative amortization"), rather than increasing the size of the monthly payment.

The liberalization of regulations is expected to result in an increased supply of funds flowing into mortgages. But the increased variability of interest rates shifts much of the risk from thrifts to individual borrowers, thereby increasing the cost of borrowing. If adjustable-mortgage loans had been available in September 1978, for example, tying the interest payment to six-month Treasury bills would have boosted the average monthly payments by about 34% over the cost of a fixed-rate loan.

This increase in the cost of borrowing will reduce the demand for mortgage funds in two ways: fewer people will qualify for financing, and other downward pressures on house prices will arise in response to the higher borrowing costs. "Creative financings," whereby the home seller holds part of the mortgage at a below-market rate, are becoming an increasingly common way of cutting the total cost of a house. At present, it is impossible to determine whether the increased supply of funds will be more important than the reduced demand in determining the level of mortgage activity.

The move to charge homebuyers market rates of interest and to remove the protection of fixed rates represents a break with the previous policy of actively encouraging homebuying. The change is also consistent with the Reagan administration's attempts to remove market-distorting subsidies and allow market forces to direct the flow of capital into sectors with the highest rate of return.

Asia and Oceania Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
			6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	12-month changes: consumer prices	12-month changes: latest data	12-month changes: money supply(M1)	exchange rate in U.S. dollars June 3, 1981	change from year earlier June 3, 1981	current monetary conditions	
Asia	Bangladesh	Early heavy rains threaten current plantings; Zia assassination clouds overall outlook.	Oct.	+ 6%	13.7*	$ 160	Apr.	260	– 23%	1.5	289	Aid consortium pledges some $1.6 billion for fiscal 1981-82.	Feb.	+10%	Nov.	+15%	.0625	– 7%	Restrictive monetary policy continues under IMF program.	Bangladesh
	Burma	Weather conditions favor continued high growth in rice production.	Dec.	+ 15%	5.0*	154	Feb.	262	+ 11%	11.5	33	Rice exports should ensure another balance-of-payments surplus.	Feb.	+ 1%	Sept.'79	+14%	.1450	– 6%	Exchange reserves stable at about $260 million.	Burma
	China, People's Republic	Inflation-adjusted growth of 4.5% in national income seen for 1981-82.	Dec.	+ 20%	517.0*	510	Sept.	3,615	+ 13%	2.7	456	Trade figures revised upward to show deficit of $1.3 billion in 1980.	Dec.	+ 8%	n. a.	—	.5750	–15%	Austerity measures in place to reduce inflationary pressures.	China, People's Republic
	Hong Kong	Recent jump in share prices injecting some strength into sagging property prices.	Feb.	+ 25%	20.8	4,105	n. a.	—	—	—	—	Exports in first-half 1981 better than expected.	Feb.	+13%	Feb.	+ 9%	.1830	–10%	Interbank rates remain high.	Hong Kong
	India	Coal production exceeding target, helping to alleviate infrastructural bottlenecks.	Dec.	– 3%	126.3*	194	Jan.	6,995	– 8%	6.4	319	Higher domestic output and resumed Assam production cutting oil imports.	Feb.	+13%	Nov.	+20%	.1180	– 8%	Sizable budget deficit will preclude reduced money growth.	India
	Indonesia	Policies to promote local business interests gain momentum as 1982 elections approach.	July	+ 49%	63.2	417	Mar.	6,145	+147%	8.2	0	Oil, gas earnings dominate; log ban and slack markets hurt other exports.	Mar.	+17%	Nov.	+46%	.0016	0	Rapid money growth may signal rising inflation rate.	Indonesia
	Japan	Average wage rise of 7.7%, together with moderation in inflation, should boost consumer spending.	Feb.	+ 32%	1,039.6	8,902	Apr.	26,926	+ 48%	2.2	0	Auto exports to U.S., Canada restricted; EEC seeking restrictions also.	Apr.	+ 5%	Feb.	– 2%	.004465	– 3%	Rate declines reversing with arbitrage, official intervention.	Japan
	Korea	Business recovering from slump, led by shipbuilding, textiles, and overseas construction.	Mar.	+ 20%	57.8	1,513	Mar.	2,858	+ 6%	1.4	806	Exports rising strongly, but 1981 current-account gap will top $5 billion.	Mar.	+26%	Feb.	+18%	.0015	–10%	Bank and financial-market liberalization continues slow.	Korea
	Malaysia	Business activity in temporary lull, awaiting outcome of general election.	Nov.	+ 8%	22.8	1,659	Feb.	4,206	+ 5%	4.7	0	Slack world demand for commodities depressing exports.	Jan.	+ 7%	Jan.	+21%	.4255	– 9%	Government reiterates desire to keep rates low.	Malaysia
	Nepal	Real economic growth of 6%-7% expected in fiscal 1980-81, versus negative 1.5% in 1979-80.	Dec.	– 8%	1.9*	137	Apr.	166	+ 3%	6.1	23	Oil exploration accelerated to reduce oil imports.	Jan.	+12%	Dec.	+13%	.0875	+ 2%	Reduced budget deficit will help curb money growth.	Nepal
	Pakistan	Five-year U.S. aid package to include $100 million annually in economic assistance.	Jan.	+ 28%	22.9*	287	Apr.	1,083	+ 22%	2.0	530	Trade and current account deteriorating with relaxation of import restrictions.	Mar.	+15%	Jan.	+17%	.1020	0	Tight monetary policy to continue under IMF program.	Pakistan
	Philippines	Continuing recession sharply reduces profits of mining, automotive industry, and other sectors.	Dec.	+ 2[illegible]%	35.9	750	Apr.	2,526	– 1%	3.5	850	Low prices of sugar, coconut oil, and copper hurting exports.	Mar.	+11%	Feb.	+11%	.1335	0	Most interest-rate ceilings to be lifted July 1.	Philippines
	Singapore	Equity and property boom appears to be losing some steam.	Jan.	+ 22%	8.9*	3,790	Jan.	6,636	+ 12%	3.0	0	Softening of export commodity prices widens trade deficit.	Mar.	+ 5%	Dec.	+ 8%	.4645	– 1%	Rates expected to remain high in near term.	Singapore
	Sri Lanka	Industrial production increasingly constrained by power cutbacks.	Nov.	+ 3%	3.8	256	Feb.	220	– 53%	1.3	242	Imports slacken as tax-relief provision ends.	Jan.	+24%	Dec.	+22%	.0575	– 8%	Credit controls squeeze lending to private sector.	Sri Lanka
	Taiwan	Government considering opening up domestic investment market to greater foreign participation.	Dec.	+ 18%	40.3	2,282	n. a.	—	—	—	—	Recession in principal export markets affects payments outlook.	Feb.	+20%	Jan.	+30%	.0290	0	New foreign entrants intensify competition in banking.	Taiwan
	Thailand	Wait-and-see attitude by investors continues in aftermath of coup attempt.	Dec.	+ 12%	27.3*	591	Apr.	1,272	– 26%	1.8	131	First-quarter trade data show unexpectedly large deficit.	Jan.	+16%	Oct.	+14%	.0500	– 1%	Baht depreciated 1% against U.S. dollar.	Thailand
Oceania	Australia	Federal government scaled back through transfer of operations to states and to private sector.	Dec.	+ 10%	119.1*	8,260	Apr.	2,653	+ 57%	1.0	74	First-quarter 1981 capital inflow was largest on record.	Dec.	+ 9%	Jan.	+12%	1.1380	– 1%	Heavy reserve inflow pushing money growth above target.	Australia
	New Zealand	Economy buoyed by start-up of new investment projects.	Jan.	+ 8%	19.6*	6,332	Apr.	372	– 30%	0.9	123	Rapid export price increases will offset slower export volume growth.	Dec.	+16%	Jan.	+10%	.8675	–11%	Low-interest-rate policy spurs money growth.	New Zealand

*1979

World Interest Rates

market rates of June 3, 1981; bond yields as of May 29, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	18.68	12.00	14.00	9.50	7.50	19.00 penalty rate 22.00	9.00	5.00	6.25
Day-to-Day Money	19.75 June 4	20.50	11.25	15.00	20.00	12.00	19.75	11.75	6.00	7.00
Treasury Bills 91-day, Middle Rates	15.60	18.70	11.50	16.25	n. a.	n. a.	18.50 85-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	15.75 finance paper	19.10 finance paper 15% tax w/h	11.36	13.90 Certified	19.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.35	19.05 15% tax w/h	11.75	13.90 Certified	not traded	9.90	21.35	no market	n. a.	no market
Government Bonds Long-term, new and old issues, average yield	13.05	15.28	13.84	10.24 20% tax w/h	16.89	10.80	19.08	12.02	5.85	8.241
Industrial Bonds prime, long-term, new and old issues, average yield	14.20 Aa Industrials	15.75	14.94	15.70	18.03	11.45	20.41	13.29	6.46	7.14
Bank Short-Term Rate to Best Borrowers (prime rate)	20.00	19.50	13.00	18.75	18.60	14.50	22.50 ⅛ quar'ly fee on outstdng.	13.50	9.50	6.75
Bank Time Deposits 3-month	16.75 Cert. of Dep.	18.70	12.375	16.30	18.875	13.30	10.75	12.00 large deposits	10.00 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	18.375	no market	12.3125	no market	19.75	12.875	no market	11.75	10.1250	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8282	1.9950	.0259	.1789	.4216	.000851	.3799	.4751	.00446
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.7950 *D*	5.4135 *P*	1.5523 *P*	9.3023 *D*	4.6374 *P*	4.082 *D*	5.698 *P*	7.6956 *P*	9.991 *P*

Eurodollar Deposits
(London, interbank, bid)
June 4

7-day	18.75
1-month	18.75
3-month	18.3125
6-month	17.50

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.156
U.S.-Canada Treasury Bills	−1.225
U.S.-Canada Finance Co. Paper	−2.295
Eurodollars-U.K. Local Auth. Deposits	+ .024

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.50
Over 7 yrs.	15.40
DM Bonds	
7 yrs. and under	11.30
Over 7 yrs.	11.30

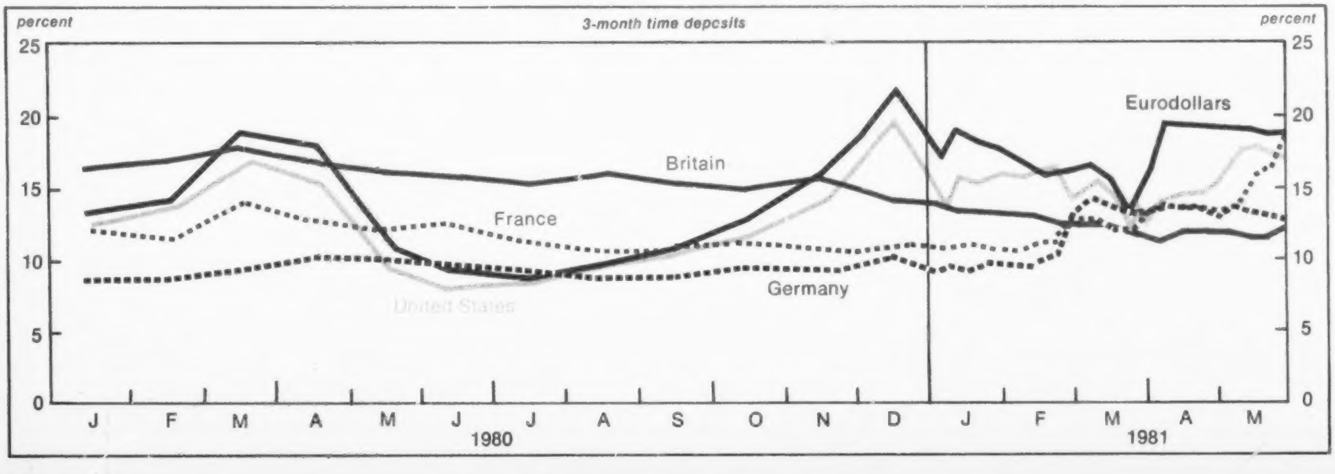
Gold Price

London
afternoon fixing

475.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Interest rate movements in major industrial countries



Export Credit Subsidies Resist Reduction

Last month's meeting of the 22 member nations of the OECD's Export Credits Group failed once again to achieve a consensus on reducing government subsidization of export credits. The countries now loosely adhering to an international accord that sets minimum interest rates and maximum repayment terms for government-backed export credits were unable to resolve their differences over amending the agreement's interest-rate guidelines. The continuing stalemate has intensified the export credits race, further distorting the world trading system with still higher levels of subsidization.

ARRANGEMENT GUIDELINES

	2-5 year credits	over 5 year credits	maturity limits, years
	(percent per annum)		
Relatively Rich Countries (GNP per capita over $3,000)	8.50	8.75	8½
Intermediate Countries (GNP per capita $1,000-$3,000)	8.00	8.50	8½
Relatively Poor Countries (GNP per capita less than $1,000)	7.50	7.75	10

The lack of progress in the latest round of negotiations comes in the wake of a heavy blow dealt the three-year-old "Arrangement on Officially-Supported Export Credits" in December 1980. At that time, an effort led by the United States and Canada to link interest-rate minimums to some measure of market rates was quashed by European—largely French—opposition. Several proposals were floated at the time, the most prominent of which was a "differentiated rate system". Under this formula, minimum interest rates in each OECD-member country's local currency would be pegged to an average yield on long-term government bonds in each member country. The European nations (the majority of which negotiate through a single European Community spokesman) rejected the notion of market-rate linkage. They countered with an offer simply to boost allowable rate minimums across the board by one percentage point for buyers in rich and intermediate countries, and 0.8 percentage points for customers in less developed countries. The Japanese, who supported the concept of market-tied interest-rate minimums, objected to a uniform rise in Arrangement interest-rate minimums because their domestic interest rates were already below the minimums. The result was a deadlock that has continued to resist resolution.

In the interim, the huge cost of subsidizing the generous export credit programs sponsored by the major industrialized nations has continued to grow more prohibitive as market interest rates have soared. Market rates in some countries are double the minimum interest rates prescribed in the agreement—and widely provided for government-backed export loans (see below). The U.K.'s export credit interest-rate subsidies alone, for example, cost the British treasury some £550 million in fiscal 1980.

	Official export credit rate[1]	Average yield on long-term government bonds (as of May 29)
	(percent per annum)	
United States	8.75	13.05
United Kingdom	7.75	13.84
France	7.75	16.89
Japan	7.75	8.24
Italy	10.10[2]	19.08
Germany	9.50-10.25	10.80
Canada	9.25-10.25	15.28

Further aggravating tensions has been a spate of violations of the export credit pact's terms in the wake of the failure of the December negotiating sessions. The U.S. Export-Import Bank, unable to offer lower rates, exceeded the maturity limits in several export transactions, while at the same time boosting rates nearer market levels. Other nations responded by introducing programs of aid-sweetened export credits for buyers in less-developed countries—so-called "mixed credits". The Canadian government established a C$900-million mixed credit facility, to be used over the next three years, while the British have set aside £2 million in aid funds to be blended with export loans during fiscal 1982 and £4 million for fiscal 1983. The Japanese have also inaugurated a mixed credit program, as have the Swedish and Dutch export credit agencies. Mixed credits, an innovation and long-time practice of the French, do not violate the letter of the export credits agreement as they are excluded from its guidelines. They do, however, violate its spirit as the aid component of such credits typically carries interest rates as low as 3½% per annum and maturities of 25 years. This reduces the overall cost of the already subsidized export credit still further.

Despite its numerous setbacks, however, the beleaguered export credits accord has not actually been repudiated—apparently reflecting its adherents' desires to avoid an all-out export credits war. The United States, which had last fall threatened to renounce the export credit agreement unless its interest-rate mini-

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[1] Rates charged by government export credit agencies on their long-term financings of exports to less developed countries.

[2] For lira credits; U.S. dollar credits are frequently offered, at rates of 7.75%.

Export Credit Subsidies Resist Reduction

(continued from page 7)

mums were linked to market rates, subsequently lost some of its bargaining power through the new U.S. administration's limits on Export-Import Bank funding. The Reagan administration opposes financial subsidies, preferring to focus its pro-export policy on changing U.S. tax, anti-bribery and banking laws. In this context, President Reagan has proposed cutting U.S. Eximbank direct lending authority for fiscal 1981 (ending September) to $5.1 billion. This compares with $5.9 billion requested by the former administration, and represents a decline (in inflation-adjusted terms) from the bank's loan authority in fiscal 1980. For fiscal 1982, the Reagan administration proposes $4.4 billion in Eximbank direct loan authority, as against the $5.0 billion sought by the Carter administration. Meanwhile, Eximbank loan activity is currently limited to honoring only previously made loan commitments under a moratorium in place since mid-February.

Thus, with the U.S. Eximbank's resources cut back and stepped-up subsidies by several other exporting nations, some of the momentum for overhauling the interest-rate terms of the existing export credit agreement has been lost. And several larger influences continue to work against a significant tightening of the guidelines. These include sustained domestic economic sluggishness in many of the industrialized nations, current-account deficits either in evidence or in prospect, and, in general, a long history of strong commitment to maximizing exports in Europe and Japan. Many countries view subsidized export credits as essential to winning export sales, particularly to purchasers in less developed countries. They also favor the status quo because of the rough comparability of national subsidies that has been achieved, but with sufficient leeway for additional non-interest-rate forms of subsidy.

Perhaps the strongest remaining incentive favoring more market-related guidelines is the huge and growing cost of subsidies. Important also is the desirability of easing tensions among the Western industrial nations over trade policy. As for the United States' powers of persuasion, the U.S. Eximbank's occasional practice of exceeding the agreement's repayment terms is a strong bargaining lever. Moreover, it appears as if Congress will restore some of the proposed cuts in Eximbank loan authority.

Possible scenarios

The reality of participants in the export pact adhering to interest-rate guidelines that move automatically in line with market rates in their respective countries seems to be virtually unattainable, so that financial subsidies will undoubtedly persist. Short of that, however, it is feasible that the Arrangement's interest-rate guidelines could still be tightened to reduce subsidy levels. In this regard, several scenarios are possible:

- The European nations could agree to raising minimum interest rates by even more than the one percentage point for the more affluent nations and 0.8 percentage points for buyers in less developed countries. But this will require some resolution to the Japanese problem—either by having the Europeans agree to allow low-interest-rate countries to lend at below the Arrangement minimums if market rates so dictate, or by having low interest-rate countries finance export sales solely through private channels so that the Arrangement guidelines do not apply.
- Another possibility is for the pact's adherents to boost only the minimum rate for buyers in developing countries by 0.8 percentage points (or more)—which would not present a problem for the Japanese whose market rates are roughly comparable—while prohibiting government financial backing for exports to other industrialized nations.
- A third option is to raise the agreement's interest rates to an average market rate based on long-term rates in all of the member nations and adjust the rates periodically—rather than have interest rates move automatically. This option, however, would also pose a problem for countries with lower-than-average market rates.

Speculating on the outcome of the negotiations is, of course, risky, particularly in view of the influence of political variables. The outcome of the French legislative elections later this month, for example, may alter the French bargaining stance, which is a critical one. And trade negotiations proceeding on other fronts will also play an influential role.

But the fundamental issue continues to resist resolution: how to reduce official export financing subsidies without giving countries with low market interest rates too strong an advantage. And the divergence in financial structures and domestic economic priorities—as well as fears over losing market shares in an increasingly competitive environment—is likely to continue to preclude the ratification of a binding accord that will permanently and sharply reduce the level of export credit subsidization.

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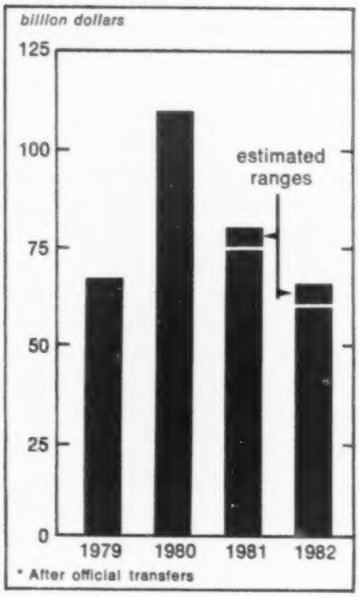
OPEC Surplus Narrowing Steadily

The world petroleum market has turned soft, with supply currently running some 2-3 million barrels per day in excess of demand. This large surplus is the result of two main influences: reduced oil consumption in the OECD nations and continued high Saudi Arabian production. Oil consumption in the industrial countries fell 7%-8% last year, owing to price-induced conservation and sluggish economic growth. At the same time, Saudi production was held at over 10 million barrels per day, compared with the pre-1979 ceiling of 8.5 million barrels per day. Despite pressure by other OPEC members at the May meeting, the Saudis refused to cut their output or boost prices (currently $32 per barrel) without obtaining reductions in the official oil prices of other OPEC members—particularly from the North African countries—whose prices ranged between $36-$41 per barrel. The result has been sharp downward pressure on the oil market. Spot prices have fallen by $7 per barrel; premiums have disappeared; and contract prices charged by some OPEC and many non-OPEC oil exporters have recently been cut or discounted by up to $4.25 per barrel.

How long these market conditions will continue remains uncertain. If the OPEC price hawks were to agree to a reduction of $3-$4 per barrel in posted prices, Saudi Arabia might respond with both a substantial production cut and an increase in the price of its benchmark crude to $34 per barrel. Under these circumstances, the price of OPEC oil would average about $35 per barrel for the year, and total OPEC oil exports in 1981 would fall roughly 11% from 1980. Assuming a 23% increase in payments for imports of goods and services, the 1981 combined current-account surplus of the OPEC countries would total about $75-$80 billion, after allowance for official transfers of some $8 billion. This compares with the $110-billion surplus recorded last year. If the Saudis do not raise their prices well before year-end, the 1981 OPEC surplus could be even smaller.

Barring adverse political developments, the OPEC surplus is likely to shrink further in 1982. Although the pace of world economic growth will be somewhat faster and progress in energy conservation slower next year, market conditions appear unlikely to warrant much, if any, of an increase in the real price of oil. If oil prices rise 10% while goods and services imports grow by 23%, the OPEC surplus on current account would drop to approximately $60-$65 billion. It should be borne in mind, however, that the assumptions underlying these estimates could be quickly invalidated by unforeseen political events in an already tense Middle East.

OPEC current account surplus*



* After official transfers

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Sterling weakness threatens higher U.K. inflation, but increased interest rates still unlikely.

After a period on the sidelines, the pound has once again been caught up in a wave of currency movements. Since the U.S. dollar's sharp recovery in early June, sterling has slipped below $2.00 for the first time since February 1979. The pound has also weakened against most other currencies, albeit to a lesser extent. Its trade weighted index (1975=100) is currently 93.8, the lowest it has been since mid-1980. This sharp decline threatens to boost the rate of inflation just when the government is intent on reducing it to single digits. Consequently, there is speculation that the authorities will raise interest rates in defense of the pound. Such a move, however, would aggravate the domestic economic recession. Industrial production is already some 9% below its year-earlier level, and unemployment is at a post-war high of 10.4%. There are few signs of near-term recovery as after-tax incomes are rising more slowly than prices, and a fall in the volume of consumption is expected. Furthermore, economic sluggishness among Britain's trading partners suggests that U.K. exports will be weak for the remainder of 1981. Higher interest rates would thus only intensify recessionary pressures. The government is therefore likely to postpone a rise in interest rates as long as possible in the hope that economic developments elsewhere will remove some of the downward pressure on sterling.

Austria's hard-currency policy compromised by DM weakness.

Recent foreign-exchange market developments are complicating Austria's "hard-schilling" policy. The schilling has been linked to the German mark since 1973. Until 1980, this linkage resulted in an appreciation of the Austrian currency that held down inflation and permitted a substantial decline in the rate of wage increase. Over the course of 1980, however, and more so in the first quarter of 1981, the DM's weakness has led to a depreciation in the schilling's trade weighted value—4.6% in 1980 and nearly 9% in the twelve months to March 1981. Such depreciation has not been justified by Austria's inflation rate relative to its trading partners. While this real exchange-rate depreciation is benefiting Austrian export industry, it is fueling inflation. Year-on-year wholesale price inflation accelerated to almost 10% in April. Critical to Austria's economic prospects is whether it can maintain wage growth of about 7%, or whether increased inflation will trigger higher wage settlements, which would render any gains in competitiveness short-lived.

Spain's economic anemia accompanied by rising inflation and worsening payments balance.

Weakness continues to characterize the Spanish economy. A slight recovery was achieved in the last quarter of 1980, but the momentum has not been sustained. Consumer demand is particularly depressed, in the face of 1.5 million unemployed—300,000 more than 12 months ago—and the public-sector deficit continues to grow at an alarming rate. The external sector is also lackluster. The peseta has weakened against the strong dollar, but not against the European Monetary System currencies. As a result, Spanish imports are tending to be more costly, but Spain's competitiveness vis-á-vis the EEC has not improved. Preliminary data for the first two months of 1981 show the current-account deficit expanding to $1.4 billion from $1 billion in the same period last year. It is widely expected that in view of the world recession, the current account will not improve, and a deficit in excess of $6 billion appears virtually certain for 1981. The only bright spot on the economic scene is the agreement between unions and employers to limit wage rises to 9%-11% in 1982. And even this is uncertain, given that the rate of consumer price inflation is 15.7% and rising.

A sharp turnaround for Japan's current-account balance.

The Japanese balance-of-payments showing has improved significantly in the last two months. The seasonally adjusted trade surplus narrowed slightly to $1.74 billion in May from $1.87 billion in April but was still nearly double the $995-million surplus recorded in March. The improved trade balance helped shift the current account into surplus by $827 million in April and $514 million in May, after running deficits of $559 million and $353 million in February and March. For the first five months of 1981, Japan recorded a current-account surplus of $332 million—a sharp contrast to the deficit of $7.83 billion posted in the year-earlier period. The continued sluggishness of the domestic economy is expected to hold down imports for a while longer. But prospects for Japanese exports, particularly of autos, are not very bright, given the world recession and rising protectionism. For the fiscal year that began April 1, automobile exports to the United States and Canada are to be restricted. And although Japan has resisted demands to restrict automobile exports to the European Economic Community as a whole, it has agreed to limit auto exports to Germany and Belgium and may consider curbs for other EEC countries as well.

Indonesian oil receipts hold firm, helping swell reserves.

Despite the current softening in world crude oil prices, Indonesian net foreign-exchange earnings from oil and gas are expected to reach $13 billion this year, pushing reserves over $12 billion even before yearend. The surcharge on one grade of crude has been reduced, but Indonesia's oil price structure has remained largely intact, averaging approximately $36 per barrel. The quality of Indonesian crude and its proximity to Japan and other Asian markets ensure that it will remain a favored supplier. Meanwhile, despite its rising reserves, Indonesia has secured pledges of continued foreign aid. The International Donors Group has agreed to provide $2.1 billion in concessional loans for fiscal 1981-82, the same amount as in 1980-81. Helped by these aid receipts, the overall balance-of-payments surplus for 1981-82 should reach $4 billion.

Puerto Rican economy affected by cutback in U.S. government spending.

The Puerto Rican economy is being pinched by the U.S. government's curtailment of public-spending programs. The reduction in CETA public-service jobs (in preparation for the planned termination of the program) has had an immediate impact, contributing to the unemployment rate's climb to 19.6% in April, up 2.1 percentage points from April 1980. Puerto Rico could be affected further by Congressional reduction of other federal programs—particularly food stamps, Medicare, and social security payments. Such potential limits on federal funds would be partly offset by the upturn in Puerto Rican manufacturing. Also, the inflation rate has been kept moderate—running at an 8.6% annual rate in April. Still, with housing and construction languishing because of high interest rates, Puerto Rico's overall economic showing in 1981 will be modest.

Nicaraguan economic revival proceeding only slowly.

Nicaragua's economy turned up on a number of fronts in 1980 following the severe destruction wrought by the 1979 civil war. Real GDP advanced 10%, after contracting by 25% in the previous year, the rate of inflation was nearly halved to 27%, and a sizable portion of external debt was rescheduled. This performance was still less satisfactory than anticipated, however, and Nicaragua remains vulnerable. GDP per capita is equal to four-fifths of the pre-war level, and about 20% of the labor force is unemployed. In addition, foreign reserves are negligible, and the country's net foreign asset position exceeds negative $415 million. Little improvement is expected in the near future. Economic revitalization requires addressing the principal constraints to growth: the lack of confidence on the part of the private sector (which controls some 60% of the country's productive capacity) and the severe foreign-exchange squeeze—both of which ultimately depend on the political evolution of the country.

Reduced supply and increased demand will put upward pressure on cattle prices.

Upward pressure on beef and cattle prices in the latter part of 1981 appears likely. Feedlot industry losses have been significant for several years now, in response to slack demand, and this has meant little or no expansion in beef supplies. Indeed, U.S. beef production in 1981 is estimated at 21.3 billion pounds, down 1% from 1980. U.S. pork production, which reached an all-time high of 16.5 billion pounds last year, is expected to be down sharply. Demand, on the other hand, appears likely to recover somewhat. Although meager gains in consumers' disposable incomes in the United States depressed beef and pork demand in 1980 and early 1981, some rebound is expected in the latter part of this year as economic recovery begins to take hold. Thus, the combination of reduced supplies and some increase in demand will put upward pressure on cattle prices later in the year.

BEST AVAILABLE COPY

International Banking Facilities Approved

The Federal Reserve has finally authorized the establishment of international banking facilities (IBFs) at banking offices within the United States. This action—to take effect December 3—is potentially one of the most far-reaching developments in Euromarkets in over a decade.

An IBF will function as an offshore branch. It will not be subject to Federal Reserve reserve requirements or rate ceilings on deposits. Moreover, in several states (including New York), IBFs will not be subject to state and local income taxes.

General powers

Beyond these, there are both differences and similarities between IBFs and typical offshore branching powers. IBFs will not offer transaction services such as checking accounts. Credit extended by and deposits received by IBFs must be related to non-U.S. activities. Borrowers as well depositors must be foreign residents, except that an IBF may also deal with other IBFs and with its U.S. parent. Time deposits issued by IBFs will be non-negotiable, with a minimum maturity or notice of probably two days for nonbank customers (the final regulations have not been issued). Interbank transactions—involving other IBFs, foreign commercial and central banks, and foreign official institutions—will have a minimum one-day maturity. A minimum transaction size will also be imposed on deposits to and withdrawals from IBF accounts (probably $100,000). Loans and deposits may be denominated in U.S. as well as foreign currencies.

At least two requirements, however, threaten to impose serious handicaps on U.S. banks establishing IBFs. First, the Federal Reserve's two-day minimum maturity on nonbank time deposits will deter the placement of funds by depositors seeking the flexibility of overnight positions. Second, FDIC deposit insurance will apparently be extended to the first $100,000 of IBF deposits. This will mean a premium assessment of 1/12 of 1% (or about 8 basis points). This is an unnecessary cost in a highly competitive market where spreads are often as little as 10-15 basis points.

Competitiveness implications

The basic objective in providing for IBFs has, of course, been to attract international financing business from offshore locations to the United States. Initially, a sizable shift to IBFs is likely from Caribbean sites such as Nassau and the Cayman Islands. In addition, a relatively small shift to IBFs will also take place in "IBF-eligible" loans and deposits (mainly of foreign banks and governmental entities) now booked at U.S. domestic banking offices.

The most uncertain element of longer-run IBF growth lies in the ability of IBFs to capture a share of the financing business that in the past has gone to London and, increasingly, to Bahrain, Singapore, and other offshore centers. At least two factors play central roles in the outlook for changes in market shares. First, U.S. banks have found facilities and personnel costs in overseas centers to be considerably higher than in the United States. From an operating standpoint alone, assuming no differences in other factors, there is strong incentive to seek a greater home orientation to new business.

How much Euromarket business returns to the United States will also reflect differences between the United States and other centers in funding costs and loan spreads. In essence, the question is whether—and to what degree—investors will accept somewhat lower interest rates from IBFs in the United States than rates paid in non-U.S. centers. In the past, it has been virtually impossible to estimate the impact of differences in locational preference because of the U.S. regulations. Eurodollar time deposit rates have tended to be higher than domestic U.S. certificate-of-deposit rates by roughly the size of U.S. reserve requirements (around 65 basis points at current interest rates) and deposit insurance premiums (about 8 points). For example, in May 1981, the three-month Euro time-deposit rate averaged 18.95% and CDs, 18.20%.

The risk preferences (or aversions) associated with the United States versus political jurisdictions of other Euromarket centers will be reflected in market rates once IBFs commence operations. If those preferring exposure to the sovereignty risks associated with the United States (presumably including many U.S. multinationals) accept a slightly lower deposit rate—even 15-20 basis points—a substantial volume of rate-sensitive offshore credit demands could be expected to move to IBFs.

Of course, even with somewhat lower deposit rates in, say, New York, a shift of Euromarket borrowing to a New York IBF would also require that spreads between funding costs and loan rates not be wider than in London or other major centers. From current indications, it seems likely this condition will be met. Most major Euromarket participants are already established in the United States, and most of these could operate an IBF. Moreover, a number of U.S. banks having little or no direct Euromarket participation would probably find it desirable (and relatively inexpensive) to establish an IBF. This could be done in a bank's head office or through an Edge Act office in another area. While most of these institutions may be relatively small by Euromarket standards, they are likely to play aggressive roles, especially in dealings with U.S. multinationals.

In sum, the authorization of IBFs is a major step in the deregulation of U.S. banks in international financial markets. A sizable amount of financing business is likely to return to the United States in coming years. This will reflect greater competitiveness of U.S. banks, not only in terms of their operating efficiencies, but also in the financing terms that can be offered to both depositors and borrowers.

Richard C. Aspinwall

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes				exchange rate in U.S. dollars	change from year earlier	current monetary conditions	
												latest data	consumer prices	latest data	money supply(M1)	June 17, 1981			
Argentina	First-quarter GDP stagnant; agriculture and manufacturing decline while financial services gain.	Mar.	— 3%	127.0	$4,550	Feb.	4,538	— 53%	5.8	0	Peso devalued 30% on June 2.	May	+ 88%	Mar.	+ 80%	.00026	—57%	Interest rates at high levels.	Argentina
Brazil	Industrial output slowing because of monetary and fiscal restraints; inflation eases slightly.	Apr.	+ 26%	237.2	1,991	Apr.	5,285	— 20%	2.5	0	Increased gasohol output cuts oil import demand.	May	+120%	Apr.	+ 57%	.0125	—39%	Domestic bank loans more costly than foreign loans.	Brazil
Chile	Foreign investments of $188 million approved in Jan.-Apr., nearly equal to all approvals in 1980.	Mar.	— 12%	22.8	2,060	Apr.	3,297	+ 40%	6.0	93	Exports down 12.5% in first quarter.	Feb.	+ 29%	Dec.	+ 57%	.0270	0	Foreign reserves growth decelerates.	Chile
Colombia	Rapid growth of auto industry spurs added employment and exports.	Dec.	— 11%	36.8	1,360	Apr.	4,703	+ 14%	11.0	0	Coffee export earnings decline.	Mar.	+ 29%	Dec.	+ 28%	.0210	—13%	Bank loans growing rapidly.	Colombia
Costa Rica	Restrictive fiscal and monetary policies to be pursued.	Mar.	— 12%	4.8	2,130	Apr.	104	+ 28%	0.9	51	First-quarter trade gap was $91 mn., vs. $118 mn. in first-quarter 1980.	Dec.	+ 18%	Dec.	+ 17%	.0610	—49%	Credit policy restrictive.	Costa Rica
Dominican Republic	Cement output, an indicator of construction, down 1 million bags in first quarter from 1980.	Nov.	+ 14%	7.1	1,310	Apr.	170	+ 58%	1.3	30	Imports in first quarter up 10% from year earlier.	Nov.	+ 8%	Dec.	+ 3%	Par	—	Liquidity is tight.	Dominican Republic
Ecuador	New president, Osvaldo Hurtado, faced with problems of inflation and export decline.	Apr.	— 10%	9.2	1,100	Apr.	802	+ 1%	4.5	0	Oil price softness affects export earnings.	Mar.	+ 15%	Mar.	+ 31%	.0350	— 5%	Bank reserve requirements raised from 25% to 28%.	Ecuador
El Salvador	Agreement with Mexico and Venezuela should ensure adequate oil supply through 1982.	Sept.	+ 3%	3.8	840	Apr.	88	— 14%	1.1	7	Sugar output up 17% from 1979/80; coffee and cotton down 10%, 23%.	Dec.	+ 19%	Mar.	— 6%	.4025	0	Credit availability limited.	El Salvador
Honduras	Coffee production seriously affected by spread of disease.	Dec.	+ 3%	2.4	654	Jan.	138	— 33%	1.5	14	Tourism down sharply; evidenced by 30% decline in hotel occupancy.	Aug.	+ 18%	Mar.	+ 4%	.5025	0	Restrictive monetary policy prevails.	Honduras
Jamaica	Eight state-owned hotels offered for sale as part of divestment program.	Nov.	+ 26%	3.2	1,460	Mar.	96	+ 7%	0.9	411	World Bank loan obtained to boost exports, rehabilitate banana industry.	Nov.	+ 30%	Jan.	+ 24%	n. a.	—	Monetary policy is restrictive.	Jamaica
Mexico	Surveys indicate continued rapid investment spending, but increased concern about inflation.	Feb.	+ 63%	167.0	2,300	Nov.	2,795	+ 45%	1.5	0	Oil export price reduced by $4 per barrel.	Apr.	+ 29%	Jan.	+ 34%	.0410	— 8%	Mexican withholding tax inhibits U.S. bank loans.	Mexico
Nicaragua	To spur cotton output, authorities eliminate export tax, increase credit and foreign-exchange supply.	Dec.	— 22%	1.9	730	Nov. '79	85	+ 42%	4.5	26	Pick-up in output of major cash crops will boost export earnings.	Dec.	+ 27%	Aug.	+ 90%	.0995	+ 1%	Interest rates on 3-6-month time deposits set at 9%.	Nicaragua
Panama	Commercial, services, and free-zone activity giving strong boost to business spending.	Dec.	+ 11%	3.5	1,805	Mar.	80	— 11%	0.7	35	Shipping congestion eases in Canal.	Feb.	+ 9%	Dec.	+ 10%	Par	—	Credit available.	Panama
Paraguay	Economy growing at 10% real pace, led by agriculture and construction.	Feb.	+ 20%	4.6	1,505	Apr.	802	+ 24%	14.3	0	Hydroelectric plant financing offsets payments deficit.	Feb.	+ 19%	Dec.	+ 26%	.0080	0	Loans to exporters have priority.	Paraguay
Peru	Automobile assemblers gearing up to increase production this year.	Dec.	+ 11%	17.2	965	Nov.	1,923	+ 63%	8.2	420	Imports of $870 million in first quarter nearly double year-earlier total.	Mar.	+ 58%	Nov.	+ 55%	.0025	—38%	Lending rates lowered slightly.	Peru
Puerto Rico	Manufacturing activity rises in response to strong U.S. first-quarter GNP advance.	Feb.	— 4%	11.4	3,530	Mar.	6,519*	+ 9%	—	—	Slowdown planned for U.S. transfer payments.	Apr.	+ 9%	Mar.	+ 15%	Par	—	Business loans in Jan.-Mar. up 14%.	Puerto Rico
Trinidad & Tobago	George Chambers, new Prime Minister, stressing natural gas development.	Feb.	+ 18%	5.4	4,780	Apr.	2,848	+ 27%	10.7	0	Reserves at record high in April.	Mar.	+ 16%	Jan.	+ 22%	.4300	+ 3%	Bank liquidity is ample.	Trinidad & Tobago
Venezuela	International reserves up nearly $2 billion from Dec. '80 to April, spurring faster money growth.	Jan.	+ 24%	51.4	3,690	Apr.	8,475	+ 41%	9.3	0	Residual fuel prices cut $2.25-$3.75 per barrel; output to be cut 10%.	Apr.	+ 17%	Mar.	+ 27%	.2332	0	Net foreign assets rising.	Venezuela

*Commercial bank assets

World Interest Rates

market rates of June 17, 1981; bond yields as of June 12, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	19.07	12.00	13.00	9.50	7.50*	19.00 penalty rate 22.00	9.00	5.00	6.25
Day-to-Day Money	19.75 June 18	20.50	11.00	8.60	20.00	11.90*	19.875	11.375	3.50	7.3125
Treasury Bills 91-day, Middle Rates	14.20	18.70	12.125	15.75	n. a.	n. a.	18.50 71-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	15.00 finance paper	19.20 finance paper 15% tax w/h	12.9375	12.90 Certified	19.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	15.65	19.10 15% tax w/h	12.125	12.90 Certified	not traded	9.90*	22.90	no market	9.625	no market
Government Bonds Long-term, new and old issues, average yield	12.88	15.05	14.31	10.583 20% tax w/h	16.945	10.75*	19.64	11.43	5.77	8.281
Industrial Bonds prime, long-term, new and old issues, average yield	14.00 Aa Industrials	15.78	15.29	15.746	18.26	11.30*	21.41	13.05	6.5625	7.17
Bank Short-Term Rate to Best Borrowers (prime rate)	20.00	20.00	13.00	18.25	20.60	14.25	22.50 ⅛ quar'ly fee on outstdng.	13.50	9.50	6.75
Bank Time Deposits 3-month	17.78 Cert. of Dep.	18.50	12.6875	15.30	19.50	13.05*	10.75	11.875 large deposits	9.00 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	17.00	no market	12.625	no market	20.50	12.50	no market	11.75	9.75	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8296	1.9990	.02611	.1790	.4257	.000855	.3830	.4883	.004523
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.327 *D*	4.8024 *P*	2.2976 *P*	2.5055 *D*	5.0234 *P*	6.4957 *D*	5.5055 *P*	7.2265 *P*	9.5884 *P*

Eurodollar Deposits

(London, interbank, bid)
June 17

7-day	18.25
1-month	16.75
3-month	16.75
6-month	16.3125

International Arbitrage

(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.94
U.S.-Canada Treasury Bills	−2.09
U.S.-Canada Finance Co. Paper	−2.61
Eurodollars-U.K. Local Auth. Deposits	n. a.

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.00
Over 7 yrs.	14.75
DM Bonds	
7 yrs. and under	10.75
Over 7 yrs.	10.50

Gold Price

London afternoon fixing

461.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of June 10; bond yields as of June 5.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	10.0 (Apr.)	12.3 (May)	12.0 (Apr.)	12.7 (Apr.)	5.6 (May)	20.5 (May)	5.9 (May)	5.2 (Apr.)
Industrial production*	6.1 (May)	0.3 (Mar.)	−7.6 (Apr.)	−8.0 (Mar.)	−2.7 (Apr.)	−5.1 (Apr.)	1.0 (Dec.)	0.6 (Apr.)
Trade balance† *(billions of local currency units)*	−$3.46 (Apr.)	C$0.12 (Apr.)	£0.31 (Feb.)	−FF3.34 (May)	DM3.30 (Apr.)	−Lit.1,860 (Mar.)	−SF0.48 (May)	¥327 (Apr.)
Money supply (M1)*	10.6 (May)	6.5 (Mar.)	8.2 (Feb.)	10.1 (Jan.)	1.8 (Mar.)	12.9 (Dec.)	−3.6 (Feb.)	−2.1 (Feb.)
Velocity of money (M1)*	4.6 (Dec.)	−0.14 (Dec.)	11.4 (Sept.)	n. a.	0.6 (Dec.)	6.6 (Sept.)	n. a.	10.5 (Dec.)
Reserves minus gold *($ million, change from previous month)*	−720 (Apr.)	−547 (Apr.)	−614 (Apr.)	−60 (Apr.)	−455 (Apr.)	−2,652 (Mar.)	−1,680 (Apr.)	423 (Apr.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Relating Interest Rates and Exchange Rates

The observed relationship between exchange-rate changes and interest-rate movements underwent a major change with the Federal Reserve's adoption of its new operating policy in October 1979. Prior to the new monetary strategy, the rising trend of U.S. interest rates was accompanied by a declining dollar on the foreign-exchange markets. Since October 1979, however, U.S. interest rates and the dollar have moved together, a development that has been especially pronounced in recent weeks. A recent Chase study underscores the significance of this change for short-term exchange-rate forecasting, which relies heavily on the information transmitted to the market by interest-rate movements.

To understand the effect of the Federal Reserve's new operating strategy, it is useful to examine the significance of nominal interest rates and the market's perception of monetary policy in reacting to nominal interest-rate changes. The link between interest-rate changes and exchange-rate movements then becomes clear. Nominal interest rates comprise both a *real* component and an *inflation expectations* component. The former represents the price-adjusted return on investment, and the latter, the premium above the real return that compensates the investor for the expected change in the purchasing power of the currency in which his investment is denominated. The impact of changes in either of these two components is very different, as is market reaction to which component is perceived to have changed.

When world capital markets are in equilibrium, the demand for and supply of capital in its alternative uses are equal at the prevailing nominal interest rates. This implies that the real component of interest rates is identical across all countries (assuming the absence of effective capital controls). Under this scenario, there should not be large speculative movements of capital among countries, since there is little profit incentive. Investors will be content to earn the "world" real rate of return on their capital investments, secure in the knowledge that any differences in anticipated inflation rates are reflected in differences in the nominal interest rate. Equilibrium exchange rates will result, with the actions of speculators and arbitragers serving to smooth out daily fluctuations in exchange rates.

Adjustment of interest and exchange rates

Such an equilibrium may be upset, however, either by the appearance of a significant difference in the perceived real rate of return offered by variously denominated investments, or by a revision of inflation expectations of one or more currencies relative to others. In the instance of a shift in the anticipated real rate of return, the ensuing deviations in real interest rates are generally expected to be eliminated almost immediately—*before* any capital transactions and movement result—by the price adjustment of borrowers and lenders to shifts in relative returns. That is, exchange-rate movements, interest-rate movements, or both, will quickly eliminate the difference in expected real returns.

An important exception to this result may occur if the monetary authorities alter anticipated real returns in their pursuit of specific policy objectives. The combination of the U.S. monetary authorities' large holdings of Treasury securities and their disregard for "profits" in their market dealings may allow them to affect temporarily anticipated real returns, causing major capital movements and related exchange-rate changes in the short run. Such intervention results in a *direct* relationship between nominal interest rates and the exchange rate over the duration of the intervention. The short-run nature of these differences and associated capital flows, however, should be emphasized. Eventually, the effects of Federal Reserve domestic intervention are overcome as market participants seek to profit from the differences in perceived real rates of return across currencies.

In the contrasting case of a revision of inflation expectations, the relationship between nominal rates (assuming that the real component is unchanged) and the exchange rate is an *inverse* one. Taking the case of an upward revision of inflation expectations, exchange-rate depreciation will occur with a lag as *future* currency transactions reflect the change in relative inflation rates. This chain of events runs counter to the view held by some that changes in nominal interest rates are always synonymous with changes in real rates of return, and always move directly with capital inflows and currency appreciation.

The distinction between the real and inflation expectations component of nominal interest rates, although crucial to an understanding of the effects on foreign-exchange markets, is difficult to make in practice. To distinguish between the two, the market relies heavily on the perceived stance of monetary policy. If that policy is seen as passive and accommodating, interest-rate movements are interpreted as reflecting changes in inflation expectations alone, and will be associated with exchange-rate changes at some time in the future. In this instance, there is no reason to believe that expected real rates of return will have altered significantly, and, thus, no incentive for capital movements. If, on the other hand, monetary policy is seen as pursuing certain targets with respect to the

Relating Interest Rates and Exchange Rates *(continued from page 7)*

money supply with determination, then changes in the real component of interest rates may become significant in determining capital movements and exchange-rate changes, especially in the short run.

Just such a contrast of attitudes and reactions to Federal Reserve policy was found in the Chase study. The study examines the relationships among U.S., West German, and U.K. interest and exchange rates, both before and after the October 1979 change in the Fed's operating strategy. When the differences between U.S. dollar and deutschemark interest rates and U.S. dollar and sterling interest rates of identical maturity are compared with the respective exchange rates, the sudden and dramatic shift in the market's interpretation of those interest-rate differentials shows up clearly with regard to *both* exchange rates. This despite any differences in the operating strategies of the foreign monetary authorities.

Using weekly data, the pre-October 1979 period reveals a significant direct link between relatively higher U.S. interest rates and dollar *weakness*. This would appear to confirm the impression that many in the market had that Fed policy was passive to inflation expectations. With the Federal Reserve committed to maintaining federal funds interest rates within a relatively narrow band, its ability to control the money supply was questioned, as was the future stability of the rate of inflation. The market identified the widening gap in U.S.-foreign interest rates as a sign of higher U.S. inflation and, consequently, future depreciation of the dollar.

The period since October 1979 tells a very different story. U.S. interest rates have been closely tied to dollar strength, reflecting the effect of Federal Reserve policy on perceived real returns in the short run. This has had the predictable effect on market perceptions: rather than continuing as dependable predictors of relative inflation expectations, weekly changes in interest rates have become dominated by changes in expected real returns (see chart below).

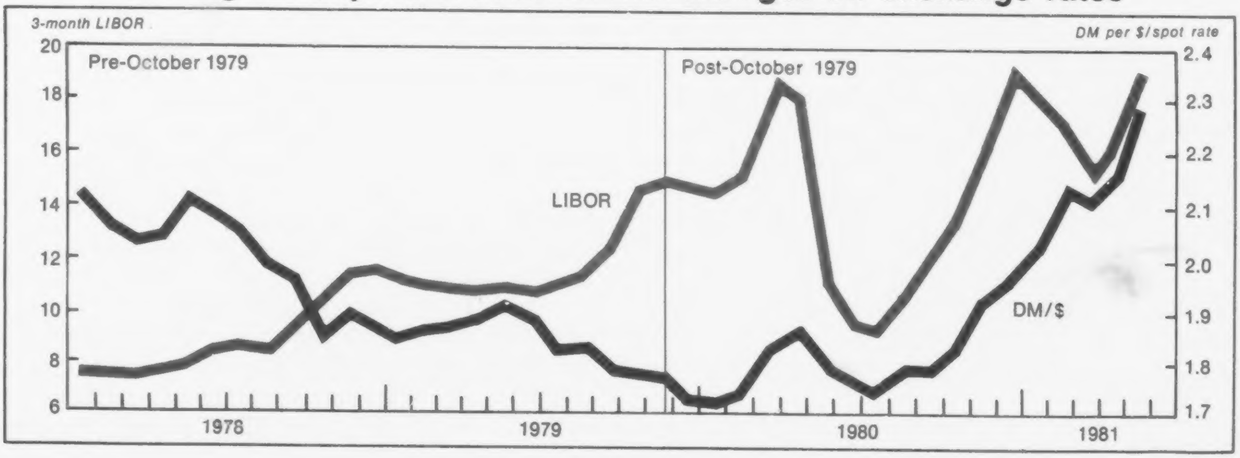
Some caveats

While it is still too early to perform this test with annual or even quarterly data, the likelihood of finding a similarly strong switch in the observed exchange-rate-interest-rate relationship is not high. Crucial to this argument is the premise that actions of the monetary authorities can affect the structure of expected real interest rates, at least in the short run. The Chase study supports such an assumption for weekly data, but the efficiency of international capital markets would argue against this assumption for longer periods.

Over the long run, the U.S. dollar's strength will reflect the success of Federal Reserve policy in reducing inflation (and inflation expectations). However, cyclical movements in the dollar can be expected as short-term real interest-rate differentials occur.

Mark Babunovic

Tracing the impact of interest-rate changes on exchange rates



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Weakening Chinese Trade Position Prompts Austerity

Although China's trade deficit with the West narrowed to $1.3 billion last year from $2.0 billion in 1979, its trade position deteriorated over the course of the year. China's trade showing was strong in the first half of 1980, owing mainly to high world prices for its oil exports, but a surge in imports and depressed export earnings in the second half brought steady deterioration to the trade accounts. The weakness has continued in 1981, with the trade balance for the first quarter in deficit by $600 million.

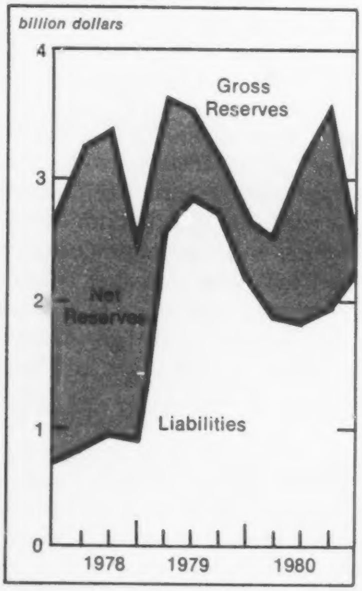
The adverse shift in China's trade balance in the second half of 1980 created financing problems for the Chinese authorities. Unanticipated short-term financing needs associated with the fast growth in imports prompted a $275-million drawdown from the IMF and a decline of some $1.3 billion in China's net position with international banks in the final quarter of last year. The IMF was called upon again in early 1981 for another $565 million.

The shift in China's external accounts and in the financing outlook led the authorities to cancel several large foreign contracts. It also prompted China's Vice Premier to unveil a restrictive budget that proposes to reduce capital investment expenditure and to cut spending by administrative organizations and the military. (The cuts in centralized investment will be partly offset by increased investment by some provinces and municipalities.)

The outlook for 1981 and 1982 is for larger trade deficits—averaging $2 billion each year. The slowdown in worldwide trade will constrain export growth, while domestic production problems are expected to reduce the volume of oil exports and limit the growth of coal exports. Recent delays in negotiating contracts for exploratory drilling mean that additional earnings from oil exports will probably not appear before the late 1980s. On the import side, the need for agricultural goods, fertilizer, steel products, and machinery is likely to increase steadily.

Should China's trade deficit with the West continue to expand in the next several years, ample funding will be available from foreign official sources and from the international capital markets. Furthermore, despite the decline in China's reserves at end-1980, reserves still exceed liabilities to international banks. The recent shifts in Chinese policy with respect to capital investment and foreign projects, however, may discourage both long-term financing by banks and joint ventures with foreign firms. Greater reliance upon short-term counter trade, equipment contracts, and official export credits is highly probable over the next two years.

China's reserve position with Western banks



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New Socialist government reflating French economy.

France's new Socialist government is pressing ahead with its economic program. A 10% increase in the minimum wage was instituted June 1, and substantial rises in social welfare payments took effect July 1. The combined cost of these social welfare increases is estimated at 9 billion francs. A series of measures that boost spending on housing, jobs, and industrial investment was also announced. Soft loan facilities to depressed sectors of industry will be extended to side-step the increase in the cost of credit resulting from moves to protect the franc. And aid will be stepped up to help reduce youth unemployment, with the objective of providing jobs for 650,000 graduates in the fall. To help finance these measures, 6.8 billion francs will be raised in supplementary taxes. A new "super tax" on higher incomes will be introduced, along with a windfall profits tax on banks and oil companies and a higher rate of value-added tax on luxury goods. The consensus among private forecasters is that the new economic program will result in real GDP growth of 4%-5% in 1982. This compares with the expectation of zero real economic growth in 1981. Faster growth next year, however, is likely to be achieved only at the cost of 15% inflation and a current-account deficit of 70-100 billion francs. Currently, industrial production is 8% below its year-ago level, inflation is running at 12.7%, and the seasonally adjusted current-account deficit was 10.1 billion francs in the first quarter.

Denmark's GNP will contract again this year.

Denmark is showing gradual improvement in its economic position. Recent wage settlements have come in well below the rate of inflation, bringing with them a decline in the purchasing power of domestic consumers. Real consumers' expenditure dropped by 3½% in 1980 and is expected to fall and additional 1½% this year. Fixed investment has also declined, and, as a result, GNP is expected to contract by ½% this year after dropping 1% in 1980. The economic slowdown has benefited the external accounts. The 1981 current account is expected to stabilize at about 14 billion kroner, with the trade balance likely to improve over the course of the year. The trade balance for the first five months of 1981 shows a kr. 5.32-billion deficit, as against a kr. 7.56-billion deficit in the year-earlier period. Inflation is also expected to improve slightly, with the price index likely to advance 9½% after a 10¾% climb in 1980. These improvements, however, have been bought at the expense of rising unemployment. The rate of unemployment averaged 6.9% last year and is expected to average 8.5% this year. This will increase the pressure on the government to reflate the economy and could thereby reverse some of the earlier economic gains.

Greek Cypriot economy departs from fast-growth track.

Real economic growth in the Greek Cypriot economy slowed to 4.9% last year from 7.3% in 1979. The slowdown ended a pattern of remarkable real economic growth (over 14%, on an annual average basis) that continued from 1975 through 1979—which constituted a pronounced recovery from the 1974 Turkish invasion and partition of Cyprus. But in 1980, higher oil prices and signs of production capacity constraints boosted inflation and widened the current-account deficit to $245 million from $205 million in 1979. This prompted a tightening of economic policy in the second half of 1980 and marked the beginning of a "growth recession". While the post-invasion reconstruction phase is now over and lower growth rates than in 1975-79 will likely prevail, much depends on the policies of the new government elected in May.

Strong import demands expanding Mexico's trade deficit.

Mexico's trade deficit for the first quarter of 1981 was more than double its year-earlier shortfall. The annualized deficit was $1.8 billion in January-March 1981, compared with an annualized deficit of $0.8 billion recorded in the first quarter of 1980. Exports increased rapidly enough in the first quarter, led by a 92% gain in petroleum sales. But large demands for industrial raw materials and capital goods caused imports to outpace exports. The total deficit for 1981 will ultimately depend on the price and volume of Mexican oil exports, which now account for three-fourths of total exports. But pricing policies are uncertain, with a markdown in prices followed by a decision to reverse some of the decline. Acknowledging the fundamental stability of oil prices and the likelihood of continued strong import needs, a 1981 trade deficit equivalent to or slightly larger than the $3.26-billion deficit recorded last year is expected.

Dominican Republic pursuing restrictive policies to check current-account deterioration.

The Dominican Republic's current-account deficit widened to $800 million in 1980 from an average $300 million in 1978 and 1979, but the pursuit of restrictive demand-management policies promises some improvement in 1981. The central government budget has been in virtual balance for the first five months of this year, in contrast to a deficit equal to 3% of GDP for 1980 as a whole. During the same period, the money supply showed no growth from its year-earlier level. Furthermore, the authorities have channeled more transactions to the parallel market and imposed additional import restrictions. These include banning motor vehicle imports for one year, establishing a quota system for industrial raw material imports, and limiting the amount of foreign exchange that the state food marketing agency can obtain at the official rate. Taken together, these measures are likely to permit a small narrowing in the 1981 current-account gap to $650-$700 million.

Rapid economic growth in Australia coupled with widening current-account gap.

Australian economic growth has been stronger than expected. For fiscal 1980-81, ended June 30, real growth is estimated at 4.7%—the highest in nine years. At the same time, the current account is firmly in deficit, with the shortfall estimated at over $4.8 billion in 1980-81. An adverse current-account showing is likely to continue in the near future, owing to the likelihood of weak export growth and commodity prices and no moderation of imports or in the invisibles deficit. The current-account outlook, however, does not presage a weakening Australian dollar. Capital inflows will more than cover the current-account deficits, and the overall balance for fiscal 1980-81 is likely to show a surplus of some $1 billion. As long as such fundamental incentives for capital inflows as resource potential and interest differentials persist—which is likely—the Australian currency will remain strong.

Angolan economy recovering steadily, paced by oil output and exploration.

The Angolan economy is steadily progressing in its recovery from the contraction that followed the 1974-75 civil war. The vital petroleum sector has already restored oil output to its pre-war level of 160,000 barrels per day, and OPEC membership is envisioned for next year. Diamond production is also rising rapidly, with a pre-independence output level of 2.2 million carats forecast for 1983. More importantly, the liberal investment code and sound economic management policies of the government are attracting increasing numbers of foreign firms—particularly to uncover new oil reserves. While economic data are incomplete, it is estimated that Angola enjoyed double-digit real economic growth in the 1978-80 period. The current account is believed to have registered a $575-million surplus last year, with this year's surplus projected at $425 million. Assuming political stability in southern Africa, Angola's economy could be poised for a take-off over the medium term.

Rice production up, but consumption still exceeding output.

World rice production is estimated at a record 265 million tons (milled basis) for the 1980-81 crop year, up 4.4% from 1979-80. The increase occurred despite major crop losses attributed to exceptionally cold weather in Japan and South Korea; record output in India, Bangladesh, Thailand, Burma, and Indonesia more than made up the difference. Nevertheless, rice consumption continues to exceed production, although by only a small margin. Carryover stocks will therefore remain low. Favorable weather conditions in the areas that enjoyed record production in 1980-81 imply a modest further increase in world rice production in 1981-82. If the expected crop materializes next year, world production should be approximately in line with consumption.

Inflation Easing: But for How Long?

The Consumer Price Index rose only 0.7% in May, bringing the year-over-year rate of price increase below the 10% level for the first time since February 1979. The sharpest price declines of late have shown up in commodity prices, with the Dow Jones spot index currently 15% below its year-earlier level. But while there are indications that the rate of price rise will slow further in the coming months, it is much too early to declare final victory in the battle on inflation.

Some economists have noted that the improvement in inflation evident recently is normal for this stage of a business cycle. They argue that wage demands moderate slowly in response to the higher unemployment generated during a recession, and that the upturn in productivity in the early stages of a recovery further eases labor cost pressures. And they note that now, as in 1976 (a post-recession year during which the CPI rose only 5% versus a 12% climb in 1974), food price increases are small, and energy prices are soft. This time around, however, added help in curbing inflation is coming from smaller house price rises and a strong dollar.

It is perhaps more useful to focus on the role that restrictive monetary policy has played in damping inflation. First, it has abetted the cyclical improvement in productivity. At the end of a recession—the present circumstance—actual inflation is below expected inflation. Consequently, previously contracted for nominal wages are more costly to employers. To be able to pay this higher real wage, employers strive either to induce higher productivity or reduce the labor content of a unit of output.

Second, the higher interest rates that have resulted from the Federal Reserve's shift to an aggregates targeting policy have also reduced inflationary pressures. Interest carrying costs have reinforced the liquidation of cattle herds, which has eased beef prices; higher interest costs have also reduced prices of agricultural products and commodities in general. And with the cost of financing a house having risen sharply, it is no surprise that house prices have moderated. Moreover, large real interest-rate differentials have kept the U.S. dollar strong, reducing import costs and moderating pressures for a higher dollar-denominated oil price. But if not for the overall restrictiveness of monetary policy, relative price declines in these areas would have been accompanied by relative price increases of other goods.

The impact of past and current monetary restraint can be expected to linger at least until the end of 1982. But additional gains in reducing inflation depend upon further tightening of monetary policy, which has not occurred at this stage of previous expansions. It is vital, therefore, for the Reagan administration and Congress to support the Federal Reserve in its resolve to maintain its restrictive stance.

The Sticky Funds Rate

Money growth has decelerated significantly in the last two months. From April 22 to June 17, seasonally adjusted M1-B actually fell by almost $8 billion. This drop has offset to a large extent the bulge in M1-B growth in the March/April period that many analysts believe was a major catalyst for the Federal Reserve's subsequent credit-tightening moves.

Somewhat surprisingly, however, the federal funds rate has not really come down in response to the sharp decline in money growth. Generally, when money growth runs below target, Fed actions designed to bring money growth back on target result in a decline in the federal funds rate—although with some lag.

There are several possible explanations for this somewhat uncharacteristic behavior. One is that while the narrowly defined money measures have fallen below target, the broader monetary measures—M2 and M3—are still above their longer-run growth targets. For example, M1-B is below the lower bound of its target growth range, especially after being adjusted for the effect of the expansion of NOW accounts this year. In contrast, M2 is slightly above and M3 is quite a bit above the upper bounds of their respective long-run target ranges.

Another possible reason is that the Federal Reserve may be pursuing an asymmetrical policy; that is, it may currently be less willing to tolerate excessive money growth than weak money growth. The Fed may be concerned that in the absence of a significant slowdown in total spending, a resurgence in money growth later this year is probable, especially if money-market rates fall sharply in the near term. This in turn might necessitate sharp credit-tightening moves later in the year.

Yet another possible reason is that while M1-B growth has been weak, short-term business credit demands have been quite strong. Large tax-related borrowings around June 15, and perhaps end-of-quarter borrowings related to balance-sheet window dressing, have recently contributed to this strength.

Finally, the time lag between a slowdown in money growth and a downward movement in money market rates is not constant. Indeed, the federal funds rate has at times remained high for several weeks after the Fed has altered its reserves targets in a manner usually consistent with a declining funds rate.

Identifying the specific reasons for a continued high federal funds rate is difficult. This is in large part due to the lack of information the Federal Reserve provides the public regarding its short-run targets for the money supply and bank reserves and the relative weights it attaches to the behavior of the various monetary measures in making policy decisions. Barring a near-term sharp jump in the money supply, however, past experience suggests that some downward pressure on the funds rate is likely over the next few weeks.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
													12-month changes				exchange rate in U.S. dollars	change from year earlier		
			6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	June 30, 1981		current monetary conditions	
Africa	Algeria	Japanese consortium to build $270-million LPG plant; Arzew LNG-2 plant nearing completion.	Feb.	+ 19%	29.0*	$1,525	Apr.	3,837	+ 16%	4.9	0	Oil output holding steady at 900,000 bpd.	Dec. '79	+ 12%	Nov.	+ 20%	.2355	−14%	Net foreign assets as of end-1980 up 30% from 1979.	Algeria
	Egypt	Budget surplus of $381 million officially projected for 1981-82, versus $313 million in 1980-81.	Oct.	+ 53%	16.4*	400	Dec.	1,046	+ 98%	3.4	140	Oil output averaged 595,000 bpd in 1980, up 13% from 1979.	Nov.	+ 19%	Nov.	+ 24%	1.45	0	IDA lends $56 million for water supply project.	Egypt
	Guinea-Conakry	Markets formerly state-controlled being opened to private sector.	Dec.	+ 11%	1.5	270	n. a.	—	—	—	—	Tourism to be bolstered by building program for 1983 OAU conference.	n. a	—	—	—	.0600	n. a.	New currency to be introduced soon.	Guinea-Conakry
	Ivory Coast	Sharp cutbacks in public-sector spending could lead to real GDP contraction.	June '80	+ 21%	10.5	1,312	Jan.	27	− 48%	0.1	87	Higher debt interest payments may widen current-account gap.	Jan.	+ 17%	Aug.	+ 2%	.00351	−28%	Liquidity extremely tight.	Ivory Coast
	Kenya	Import restraint affecting economic output.	Dec.	− 6%	7.1	440	Apr.	422	− 36%	2.6	215	Foreign-exchange shortage causing payments delays.	Mar.	+ 10%	Feb.	0	.1275	− 7%	Credit tightness continues.	Kenya
	Libya	Government expenditure on infrastructure, power projects, and hydrocarbon sector rising.	Feb.	+ 6%	23.0	8,050	Apr.	13,074	+ 47%	17.0	0	Oil output down to 1.1 million bpd from 1.6 million bpd in March.	n. a.	—	Dec.'79	+ 33%	3.41	+ 1%	Credit generally available.	Libya
	Morocco	Growth rate in 1981 to be adversely affected by a drought-induced drop in farm output.	Dec.	+ 14%	15.3*	788	Mar.	423	+ 27%	1.2	395	Phosphate rock prices holding steady.	Jan.	+ 10%	Feb.	+ 8%	.1900	−27%	Claims on government rising rapidly.	Morocco
	Nigeria	Forecast $2.5-billion budget gap has serious implications for project execution.	Feb.	+ 23%	77.0	950	Mar.	9,728	+ 49%	10.1	0	Lower oil output and prices imply $3-billion+ current-account gap in 1981.	Sept.	+ 9%	Aug.	+ 15%	n. a.	—	Preferential credits for agriculture find few takers.	Nigeria
	Senegal	Real GDP decline of 6% in 1980 likely to be followed by 5% decline this year.	n. a.	—	2.9	513	Jan.	11	− 60%	0.2	88	Oil import bill likely to reach $200 million this year.	Feb.	+ 2%	Aug.	+ 7%	.00351	−28%	Liquidity very tight.	Senegal
	South Africa	First-quarter real economic growth rate slows to 4.5% from 8% last year.	Mar.	+ 4%	80.2	2,725	Apr.	807	+ 19%	0.4	0	Weak gold prices and rising imports widen trade gap.	Mar.	+ 16%	Jan.	+ 46%	1.13	−13%	Interest rates continue to climb.	South Africa
	Tanzania	Large-scale fertilizer plant to be built, utilizing natural gas as feedstock.	June	− 9%	6.0	325	Feb.	15	− 85%	0.2	94	New export incentives to take effect July 1.	Dec.	+ 36%	Nov.	+ 28%	.1235	+ 1%	External arrears increase substantially.	Tanzania
	Tunisia	State outlays on development schemes accelerating.	Dec.	+ 11%	7.1*	1,135	Apr.	520	+ 17%	1.7	0	Tourist arrivals from W. Europe down in first quarter.	Dec.	+ 10%	Feb.	+ 19%	2.04	−20%	World Bank lends $41.5 million for electric power project.	Tunisia
	Uganda	IMF grants $130-million one-year standby to support economic stabilization program.	n. a.	—	8.0	600	Dec.	17	− 26%	0.8	45	Transport, finance problems preclude filling ICO coffee export quota.	n. a.	—	Nov.	+ 41%	n. a.	—	Shilling devalued 90%.	Uganda
Middle East	Iraq	State outlays on civilian development projects expanding steadily.	Feb.	− 66%	n. a.	—	n. a.	—	—	—	0	Oil output averaged 960,000 bpd in March, versus 400,000 bpd in Jan.	n. a.	—	—	—	3.41	0	Kuwait lends government $2 billion.	Iraq
	Kuwait	Hydrocarbon sector and infrastructure to receive priority in the 1981-82/1985-86 development plan.	Feb.	− 5%	27.3	19,870	Feb.	3,713†	+ 41%	7.1	0	Oil output ceiling cut from 1.5 million bpd to 1.25 million April 1.	Dec.	+ 9%	Feb.	+ 15%	3.5525	− 5%	Credit to private sector rising steadily.	Kuwait
	Qatar	Government discussing development of large North West Dome gas field with several companies.	Feb.	+ 25%	3.2	15,214	Sept.	385†	n. a.	3.6	0	Oil output reported cut to 400,000 bpd from 500,000 bpd on June 1.	n. a.	—	Sept.	+ 9%	.2765	+ 1%	Money supply rising steadily.	Qatar
	Saudi Arabia	Rising oil exports and state outlays sustain economic expansion.	Feb.	+ 52%	117.6	19,500	Apr.	27,184†	+ 38%	11.4	0	War-relief oil export sales of 450,000 bpd to end July 1.	Dec.	+ 2%	Oct.	+ 14%	.2945	− 2%	Riyal devalued to 3.41 per dollar.	Saudi Arabia
	United Arab Emirates	Industrial bank to be set up in Abu Dhabi to finance private-sector UAE projects.	Feb.	+ 22%	16.0*	19,275	Apr.	2,353†	+ 65%	3.3	0	Abu Dhabi oil output averaged 1.24 million bpd in IQ, down 9% from IQ '80.	n. a.	—	Feb.	+ 8%	.2735	+ 1%	Reserve ratio of 15% on offshore loans in local currency.	United Arab Emirates

*1979

†Excluding state reserves

World Interest Rates

market rates of June 30, 1981; bond yields as of June 26, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	19.08	12.00	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	5.00	6.25
Day-to-Day Money	19.50 July 1	18.50	11.50	8.10	19.00	12.00	0.125*	11.75	4.00	7.375
Treasury Bills 91-day, Middle Rates	14.28	18.85	11.9375	14.75	n. a.	n. a.	18.65* 98-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	15.00 finance paper	19.25 finance paper 15% tax w/h	11.46	12.90 Certified	18.125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.00	19.25 15% tax w/h	12.00	12.90 Certified	not traded	9.90	23.40*	no market	10.00	no market
Government Bonds Long-term, new and old issues, average yield	13.42	15.90	14.36	10.5515 20% tax w/h	16.57	n. a.	19.99*	11.35	5.62	8.181
Industrial Bonds prime, long-term, new and old issues, average yield	14.40 Aa Industrials	16.25	15.31	15.596	17.98	n. a.	21.21*	12.84	6.325	7.20
Bank Short-Term Rate to Best Borrowers (prime rate)	20.00	20.00	13.00	18.25	20.60	14.50	22.50* ⅛ quar'ly fee on outstdng.	13.50	9.50	6.75
Bank Time Deposits 3-month	16.375 Cert. of Dep.	19.25	12.50	15.10	18.25	12.80	10.75*	11.875 large deposits	9.00 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	17.9325	no market	12.75	no market	24.50	12.4375	no market	11.875	10.00	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8324	1.9235	.025475	.1745	.4175	.000855	.3752	.4865	.004390
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.375 *D*	5.375 *P*	.375 *P*	5.25 *D*	5.375 *P*	6.4957 *D*	6.00 *P*	7.875 *P*	10.375 *P*

Eurodollar Deposits
(London, interbank, bid)
June 30

7-day	18.50
1-month	18.125
3-month	17.8125
6-month	17.3125

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.869
U.S.-Canada Treasury Bills	−2.35
U.S.-Canada Finance Co. Paper	−2.86
Eurodollars-U.K. Local Auth. Deposits	−0.375

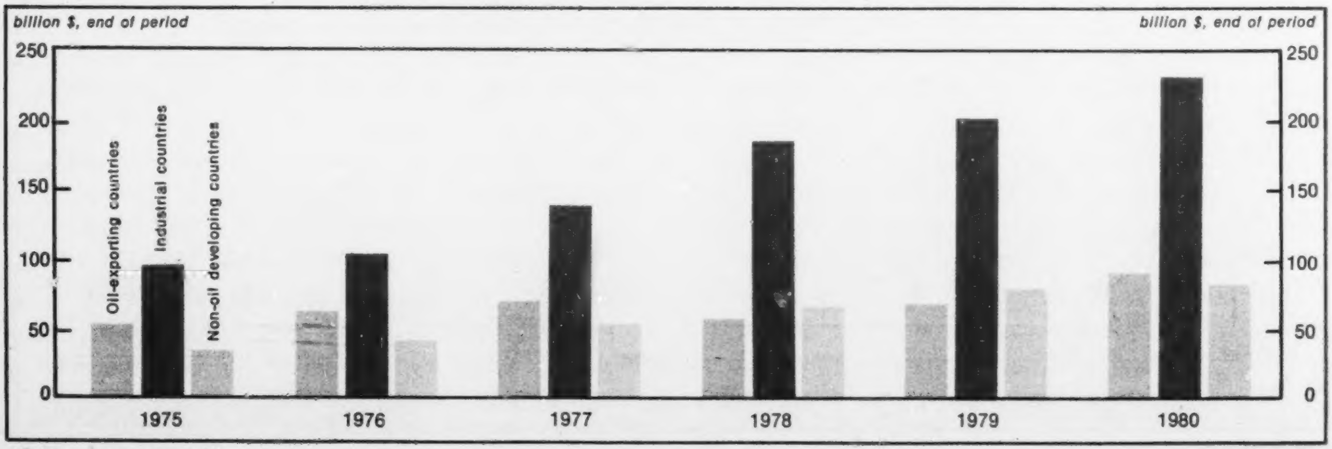
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.375
Over 7 yrs.	15.25
DM Bonds	
7 yrs. and under	11.00
Over 7 yrs.	10.625

Gold Price
London
afternoon fixing
426.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of June 24; bond yields as of June 19.

Trends in international reserve holdings*



*Total reserves minus gold

Source: IMF

Shifts in World Payments Imbalances

Current indications are that the combined surplus of the Organization of Petroleum Exporting Countries (OPEC) will decline significantly from last year's $110 billion (see June 22 issue). Oil prices for 1981 as a whole seem likely to average 10%-13% more than in 1980, a full 10 percentage points less than was projected at the beginning of the year. Oil consumption, particularly in the industrialized countries, has continued to decline, and total demand for OPEC oil in 1981 will apparently fall as much as 11% below last year's level. With imports continuing to grow rapidly, the combined surplus of the OPEC members for 1981 now seems likely to total at least $30 billion less than in 1980. And if political upsets in the Middle East can be avoided, a further decline of $15-$20 billion in the OPEC surplus is probable in 1982.

The projected shrinkage of the OPEC surplus raises the question of where offsetting improvements in international payments imbalances are likely to emerge. The preliminary answer—summarized in the table below—is not very satisfying. These "bottom-up" forecasts—that is, estimates obtained by aggregating the projected payments imbalances of individual countries—project a decline in the OPEC surplus that is markedly larger than the estimated improvement in the current-account position of the rest of the world. The sum of the estimated payments deficits for 1981 and 1982 in the table below exceeds the sum of estimated payments surpluses by more than $50 billion. If the accounts of excluded countries, principally South Africa and Israel, are considered, the statistical discrepancy approaches $60 billion, more than double the unexplained residual embedded in the balance-of-payments numbers now available for 1980. Although large year-to-year increases in this discrepancy are not without precedent, the suspicion remains that something is wrong. Either the OPEC surplus will turn out to be larger than forecast, or the improvement in the international payments position of the oil importing countries is understated. The betting here is that the latter is much more likely.

Current-Account Balances
(billion $, including official transfers)

	1980	1981 est.	1982 proj.
United States	3	2	− 2
Japan	−11	− 3	3
EEC	−41	−30	−20
OECD	−77	−60	−45
OPEC	110	80	63
Other Developing Countries	−52	−59	−60
Centrally Planned Economies	− 7	−12	−13

It does not appear likely, however, that current projections significantly overestimate the deficit on current account of the (non-OPEC) developing countries as a group. Although the less-than-expected increase in oil prices will save oil-importing developing countries some $7 billion this year, it will cost those (non-OPEC) developing countries that are oil exporters roughly $2 billion in foregone export earnings. Further, commodity prices have averaged significantly lower and interest rates markedly higher than was expected at the beginning of the year. With the *net* indebtedness of the non-OPEC developing nations to international commercial banks now over $100 billion, the worsening of the payments deficit associated with the latter effect alone will apparently exceed $2 billion. Thus, although the total payments deficit of the non-OPEC developing countries for 1981 may prove slightly smaller than forecast earlier, the conclusion remains that this deficit will be moderately larger in nominal terms this year than last, mainly because of the relatively slow growth of markets for developing-country exports in the industrialized nations. And although the more rapid growth projected for the industrialized countries next year implies both an improvement in commodity prices and a more rapid growth of developing-country export volume, it is difficult to forecast a drop in the current-account deficit of the (non-OPEC) developing countries in 1982.

The improvements in international payments imbalances offsetting the declining OPEC surplus will thus accrue mainly to the industrialized countries. The United States appears to be a conspicuous exception to this tendency, however. This year, the favorable effects of lower-than-expected oil prices have been offset by higher-than-expected economic growth and, hence, increased non-oil imports. Next year, the lagged effect of dollar appreciation will contribute to a worsened trade balance, although this shift could be overwhelmed by improved earnings of U.S. business overseas.

The most significant improvements in current-account position this year and next seem likely to be registered by Japan and the European Economic Community (EEC) countries. A sizable fall in the Japanese current-account deficit has been widely forecast; the change projected here may well be underestimated, despite the increased foreign political resistance to the continued growth of Japanese exports. There is considerably less consensus as to the balance-of-payments outlook for Europe. Despite the European recession, most analysts have tended to project a relatively modest decline in the EEC current-account deficit for 1981, largely because of concern for the "J-curve" effect of dollar appreciation. Recent data on exports and export orders suggest a more significant improvement, however. If current projections of this year's OECD current-account deficit prove too pessimistic, the bulk of the unexpected improvement will likely accrue to the EEC countries.

Investment to Spur New Zealand Growth

On the strength of stepped-up capital investment, New Zealand's economy appears poised to break out of the sluggish real economic growth path it has followed for the past few years. Real GDP growth, which is estimated at just 1% in fiscal 1980-81 (ended last March), is projected to rise to 2% in the current fiscal year and further to 3% in fiscal 1982-83.

The 1% real growth recorded last fiscal year was attributable mainly to an increase in net inflation-adjusted exports. Export volume advanced 5%, while import volume fell 6%. At the same time, real domestic demand actually declined about 2%. Agriculture and food processing turned in the strongest performances, owing to good weather.

The outlook for economic growth in the current fiscal year and in fiscal 1982-83 is notably brighter. Indeed, the period of stop-go growth with no increase in real per capita income may have now ended. The main reason is increased investment spending on a series of major industrial projects. These include an oil refinery expansion, aluminum smelter development, petrochemical projects, and, possibly, ethanol, methanol-to-gasoline, and steel projects. These projects—some already under way—are expected to boost fixed investment in real terms by some 10% in fiscal 1981-82. The investment boom will likely continue into fiscal 1982-83 and beyond, provided that the go-ahead is given to most of the projects under consideration. Inflation-adjusted consumption growth is also expected to accelerate, although a deterioration in the real external balance is likely to dampen GDP growth.

The double-digit pace of consumer price inflation, however, is expected to continue high. The inflation rate averaged near 17% in fiscal 1980-81, up from 13.8% in 1979-80. The pace of price increase is expected to ease only slightly this year, to an estimated 16%, and to some 15% in fiscal 1982-83, because of the system of informal wage indexation, the expectation of further depreciation of the exchange rate, and faster money growth.

New Zealand government policy was rather restrictive in fiscal 1980-81. Government consumption spending was held constant in real terms, capital spending fell 10%-12%, and the public deficit was kept to 5.3% of GDP, the same as in the previous year. In its November mini-budget, the government did cut income taxes 5.5% effective February 1 and took other stimulative measures to bolster the weak domestic economy. Nevertheless, a relatively neutral fiscal stance is expected for the next two fiscal years, the aim being to hold aggregate demand at its current level until the private-investment-led recovery takes hold.

New Zealand's surplus on trade account is estimated to have increased somewhat in 1980-81, to $474 million from $377 million in 1979-80. Export volume jumped as a result of agriculture's very strong showing, while import volume dropped as a result of drawdowns of stocks and little output growth in the more import-intensive manufacturing sector. The deficit on net invisibles increased as a result of higher interest payments on debt, but the modest improvement on trade account permitted a slight narrowing in the current-account gap to approximately $740 million from $772 million in 1979-80.

The balance-of-payments outlook for New Zealand over the next several years is uncertain. It depends on the price trends of New Zealand's exports and imports, its ability to obtain access to U.S., Australian, and European Community markets, and its success in diversifying its exports and markets. Although New Zealand has had some success in export diversification, the swing toward heightened protectionism in world trade is worrisome. Moreover, despite the country's abundance of natural gas, coal, and hydroelectricity, it still counts on imported oil to satisfy its liquid fuel needs, and is thus subject to the whims of OPEC.

More significantly, the investment projects already under way or planned will boost imports sharply. This, combined with the large increase in interest payments associated with mounting external debt, will result in a worsening trade and current-account balance. Large inflows of capital to finance the deficits will, however, help offset this deterioration. And when the projects go into operation, the trade and current-account balances should improve as the output generated by some of these projects (e.g., methanol, urea) is exported. In addition, if the synthetic gasoline project is undertaken—and is successful—oil imports could be reduced significantly in the latter half of the 1980s.

Thus, although the longer-term external-account outlook is for improvement, the nearer-term outlook is bearish. For fiscal 1981-82, the trade balance is projected to narrow to $450 million, while the current-account gap is forecast to widen to $900 million. In fiscal 1982-83, the trade balance is likely to approximate its showing in 1981-82, but a large rise in interest payments will expand the current-account gap further to $1.1 billion.

Financing these deficits with capital inflows, however, should prove no problem. Although external debt has risen rapidly since the mid-1970s, New Zealand's sound creditworthiness and the productive nature of its borrowing should create no difficulty in obtaining the needed capital and in managing the additional debt.

Melanie L. Lau

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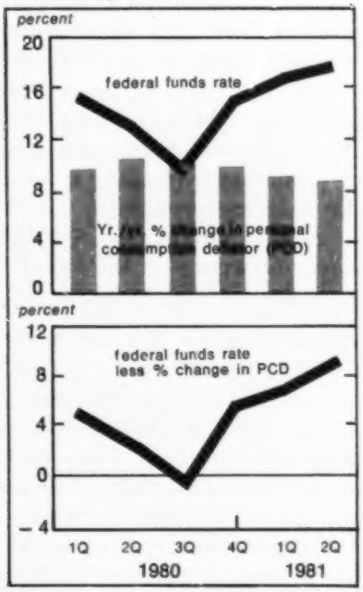
High Interest Rates Dimming U.S. Outlook

Just one year after the end of the last U.S. recession there is mounting concern about the likelihood of another downturn, possibly of longer duration. The pace of spending continues to decline in such interest-sensitive sectors as autos, housing, and capital investment. Some involuntary inventory imbalances may also be developing. Uncertainty about the economy's health is heightened by the wide margin by which interest rates have exceeded inflation. In the second quarter of 1981, the federal funds rate was more than nine percentage points above the trend inflation rate, compared with an average of three percentage points in 1980. Other interest rates show similar patterns.

In view of the duration of unusually high real interest rates, there is great anticipation about Federal Reserve Chairman Volcker's semiannual report to Congress to be delivered this week. Volcker will outline U.S. monetary policy objectives for the balance of 1981 and for 1982. The Federal Reserve's money growth targets are not expected to be high enough to sustain much "real" growth over an extended period—at least so long as the underlying 9% inflation rate persists. Indeed, the current policy response to the recent below-target performance of M1-B may be a lower target. Furthermore, there may now be added policy emphasis on the broader M2, which has been above target. Thus, during coming weeks the Federal Reserve seems unlikely to provide grounds on which to base expectations that an appreciable decline of interest rates is imminent.

Real interest rates high in U.S.



The persistence of relatively high interest rates is a major element prompting new doubts about the "consensus" economic forecast of a flat GNP in the third quarter and a relatively strong upturn in the fourth quarter. To be sure, an important basis for the projected fourth-quarter growth has been the tax cut expected to take effect in October. But timely completion of tax legislation is by no means assured. Moreover, even with the tax cut, final demand in the economy over the next few months—especially in the durables and investment sectors—may be sufficiently weak that inventory corrections later in the year will delay a strengthening of employment and production. Furthermore, for the near term the best inflation news is probably already at hand. New advances of food and energy prices, which appear likely by the fall, would diminish consumer spending power. In sum, the remarkable resilience exhibited by the U.S. economy in the past is again being put to the test. Continued restrictiveness of monetary policy may well put off any material U.S. economic recovery to 1982.

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Canadian monetary policy aimed at slowing money growth to dampen inflation.

Canada's central bank has succeeded in slowing the rate of money supply (M1) growth to an annual rate of 2.5% in June after having exceeded its targets in the two months previous. (The annualized rate of money growth was 9.6% in April and 7.2% in May.) The target range for M1 growth is currently 4%-8%, lowered from the previous 5%-9% range last February in a stepped-up effort to dampen inflation, which has been running at over 12%. The constraints on monetary growth have helped push Canadian interest rates very near to U.S. levels, with the central bank's floating rate and Canadian prime in the 20% vicinity. The authorities intend to maintain their stance as long as inflation expectations—and U.S. interest rates—remain high.

Irish economy beset by structural imbalances; curative policies nowhere in sight.

The Irish economy continues to exhibit serious structural imbalances. Much of the recent growth has come from the export-oriented industries, which now find their markets declining in view of the European recession. As a result, economic growth is slowing, and the balance of payments is weakening. At the same time, the government is running a huge budget deficit (some 9% of GNP), which results less from falling revenues in the wake of domestic recession than from mushrooming expenditure. In addition, the underlying rate of inflation is accelerating, and, following some tax increases on gasoline, alcohol, and tobacco, the consumer price index will probably end the year some 20% above its level at yearend 1980. Tough, but unpopular, government policies could set the economy on a firm recovery course. Yet given the new prime minister's fragile majority based on a coalition with the small labor party, his government is not likely to launch any major new initiatives. Consequently, there is little hope for improvement in the near term.

Israeli economic growth brisk, but structural problems need addressing.

Signs of economic growth in Israel in the first half of 1981 mask a disturbing economic picture. Inflation continues unchecked at over 130%, and the trade deficit—although having narrowed—is still running at 25% of GDP. Economic performance in the first half reflected pre-election measures to boost growth, bolster government revenues, and cut cost pressures by slashing indirect taxes. The net result was some pick-up in industrial output, but no abatement of inflation. Real GDP growth may approach 3% this year, but consumer prices are likely to rise by an average of nearly 125%. The current account is expected to deteriorate in the second half, widening the 1981 deficit to a forecast $1.5 billion from $1 billion in 1980. The fundamental long-term economic issue to be addressed is reconciling demands for a rising standard of living with growing external debt and a large defense burden. The adjustment to higher oil prices and the resultant loss of real income requires reduced domestic absorption of goods and services relative to total output. To date, this has been postponed by running a current-account deficit. The challenge to be addressed is reducing government spending, shifting the burden of adjustment from the corporate to the personal sector. But since a reduction in government spending can only be secured at the expense of social and industrial programs, any such initiatives are not likely to be significant.

Korea's new five-year plan entails revised economic strategy.

The Korean government has unveiled a preliminary outline of a new five-year (1982-86) economic and social development plan, whose substance suggests a major reshaping of economic strategy. The plan concedes that previous policies—particularly preferential loans to heavy industry—distorted Korea's industrial structure and led to higher inflation and increased disparities among income groups. The new plan, however, envisages more even-handed government encouragement of industrial investment. Furthermore, domestic producers will be exposed to foreign competition by means of import liberalization, and price stabilization will be sought by the gradual elimination of subsidies to farmers and by reducing preferential loans to industry. In the financial sector, commercial banks will be turned over to private ownership, and the capital market gradually internationalized. All in all, the plan projects, tentatively, annual average real growth of 11.9% for exports and 7.5% for GNP over the plan period.

Continued domestic economic sluggishness delaying Japanese economic recovery.

Although the Japanese economy appears to have bottomed out, the continued weakness of domestic demand is resulting in a somewhat slower-than-expected recovery. Inflation-adjusted gross national product rose at a respectable 4.5% seasonally adjusted annual rate in the first quarter of 1981, but a surprisingly strong export showing accounted for most of the increase. In real terms, private consumer spending rose at only a 1.2% annual rate, and private plant and equipment investment increased at an annual rate of less than 1%. This weakness in domestic demand is prolonging the inventory adjustment in some industries, such as steel. As a result, industrial production continues to vacillate, declining by a seasonally adjusted 1.6% in May after rising a scant 0.3% in April. However, with the 7.7% average wage increase resulting from this spring's labor negotiations and the moderation of consumer price inflation to a little over 5%, consumer spending is likely to pick up strongly. This is expected to spur a relatively sharp recovery in the domestic economy in the second half of 1981.

Brazil's economic slowdown brings relief to inflation and the trade deficit.

Brazil's economy has slowed considerably in response to policies aimed at curbing inflation and narrowing a balance-of-payments deficit. Industrial production in the first five months of 1981 showed no gain over 1980, and output is likely to continue falling over the next two to three months. The pace of inflation, however, has slowed. The general price index's growth rate declined from 7.5% in the first quarter to 5.4% in the second. Also, the trade deficit in the first half was pared by $1.75 billion to $282 million, helped largely by lower oil imports. These improvements have aided Brazil's international borrowing campaign. In the first half of 1981, nearly $10 billion in new loans was raised, which lifted reserves in May to $6.4 billion from $6.2 billion in April.

Malta's strong economic showing undisturbed by world recession and high oil prices.

The Maltese economy has performed well recently, further consolidating its dynamic performance during the 1970s, despite world recession and rising oil prices. Tourism, once again, was the main source of growth in 1980, with arrivals up 12% from 1979. Malta's external position has remained strong. The current account posted a record surplus of $125 million last year, despite the closure of U.K. military facilities; it has remained in the black through both periods of major oil price increase. Malta's external reserves, estimated at $1 billion, are sufficient to cover 15 months of imports. The only causes of concern are the recent reversal of the downward trend in unemployment and the expectation that tourism will suffer adversely because of the U.K. recession. Meanwhile, the prime minister has launched a new five-year development plan that calls for 7% average real economic growth through 1985. Priority is to be given to stimulating foreign-exchange revenues from the already successful manufacturing sector and ship repair facilities. The plan envisages the creation of 10,000 new jobs, which would return the island to full employment.

Kuwait's 1980 current account surplus was a record-breaker.

Kuwait recorded its largest current-account surplus ever last year—$15.8 billion, according to official sources, up from $14.2 billion in 1979. Oil export earnings rose 10% in 1980, despite a 37% drop in output to an average 1.39 million barrels daily, owing to a 61% jump in the official export price to $29.84 per barrel and to premiums of up to $5.50 per barrel for a large proportion of exports. The result was gross oil revenues totaling $19.2 billion last year. Imports also rose sharply in 1980, climbing by some 38% to $6.9 billion because of a more expansionary budget. The resulting trade surplus of $13.8 billion was only marginally higher than in 1979. But net service exports jumped 63% to $3.6 billion—spurred mainly by $6 billion in income from foreign assets valued at $62 billion at end-1980. This year, the current-account surplus is projected to narrow to $10-$11 billion, despite slower import growth, as oil revenues will be down significantly. The current worldwide glut of petroleum has prompted a further cut in Kuwait's output ceiling to 1.25 million barrels daily last April. Revenue per barrel of oil exported will also be lower in 1981, with official prices likely to remain stable and premiums virtually gone.

Disputing Money Fund Curbs

In the face of mounting pressure on depository institutions, Federal Reserve Chairman Paul Volcker has recently presented a plan to impose reserve requirements on money market mutual funds (MMMFs) providing checking-account services. If this proposal is enacted, the funds, like commercial banks and savings institutions, will be required to set aside a portion of their deposits in non-interest-bearing reserves. Mr. Volcker maintains that this step would facilitate the Federal Reserve's control of the money supply and improve the competitive position of depository institutions. Evidence seems to suggest, however, that imposing reserve requirements on money funds would fail to achieve these goals.

The money funds have prospered in an environment of unusually high and volatile interest rates. Depository institutions have been unable to meet investor demand for high short-term yields, however, owing to two regulatory curbs: the restrictive ceilings on interest rates payable to these intermediaries on deposits, and reserve requirements, which impose an effective tax on the use of depository institution funds.

MMMFs represent the competitive market's response to the inability of existing institutions to satisfy investor demand. But Volcker argues that the money funds have also had undesirable consequences for monetary control and competitive equity. Since many money funds offer easy redeemability by allowing check writing on deposited funds, it is possible that fund shares are being used as transactions balances. If such utilization is widespread, it blurs existing definitions of money, and, according to Volcker, weakens the Fed's ability to implement monetary policy. Moreover, the MMMFs have diverted funds away from banks and thrifts, which, hampered by regulation, have been unable to compete on an equal footing for investors' savings. Chairman Volcker's plan addresses both of these problems. By requiring the funds to place reserves with the Fed on accounts accessible by checks, a potentially unregulated medium of exchange would be brought under the Fed's control. Moreover, the holding of non-interest-bearing reserves would reduce the MMMFs' profitability and thereby remove a source of their competitive advantage over depository institutions.

The issue of monetary control calls for empirical support, since the existence of check-writing capability is not by itself evidence that investors utilize MMMF deposits for transactions purposes. What would constitute such evidence would be an increase in the turnover of MMMF assets corresponding to the increase in their asset bases over time. The ratio of total redemptions to total net assets over the last 10 quarters, however, exhibits no particular trend and has averaged a little more than 2.75 per year. Indeed, the average for the first half of 1981 is actually lower than the 2½-year average and is not significantly different from the turnover ratio on savings deposits.

Although this evidence fails to support the hypothesis that investors are using MMMFs as checking accounts, Volcker argues that further innovations by the funds, such as the availability of margin accounts and credit cards for customers, could increase the turnover rate. These services, however, are already offered by many MMMFs, and there is no evidence that they have done so.

Finally, Volcker suggests that aggregate turnover ratios may be masking a significant amount of transactions among subcategories of investors, citing the possibility of the writing of large checks on MMMF accounts to pay several small bills. But the motivation for investors to behave in this way, given high levels of interest rates, is unclear. In any event, since disaggregated turnover data is unavailable, this hypothesis remains unsupported.

The other justification given for imposing reserve requirements on the money funds is to "equalize competitive conditions" so that depository institutions can have equal access to savings. But regulating to encourage competition is a dubious approach. Furthermore, if the MMMFs were subjected to 12% transactions reserves, for example, the yield they could offer investors would decline by a bit more than two percentage points. Since the current yield spread between MMMF shares and comparably liquid accounts of depository institutions is considerably greater, the change could hardly benefit banks and thrifts. Moreover, those individual investors not having access to direct market instruments would be harmed, and the resulting decline in the yields they receive could adversely affect the level of savings in the economy.

On the other hand, there is reason to believe that the plan would not even effectively constrain the MMMFs. Since reserves would only be required on accounts with check-writing privileges, investors could avoid the reserve tax by maintaining minimum balances in reservable accounts and transferring funds from their unregulated accounts as needed.

But in a larger sense, the Volcker proposal is misdirected because it fails to recognize that the existing regulations have created the disparity between the funds and the depository institutions. As long as reserve requirements affect the yields that intermediaries can offer, the incentive to create new institutions or services to circumvent the regulations will persist. The more logical approach is thus to remove the incentive entirely by eliminating this reserve burden, allowing the Federal Reserve to pay interest on reserve balances. This would place depository institutions on an equal competitive footing and end the need for continuing regulation of new types of financial institutions and vehicles that evolve to meet investor demand for high-yielding liquid assets. The Depository Institution Deregulation Committee has moved to phase interest-rate ceilings out. The next step would be to ease the reserve-requirement burden.

Carl Alan Batlin

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	central bank rate July 15, 1981	exchange rate in U.S. dollars July 15, 1981	current monetary conditions	
Austria	Economy showing signs of bottoming out, but no sharp upturn foreseen.	Oct.	+ 3%	75.8	+ 3.6%	May	4,371	+ 21%	2.4	0	Devaluation of real exchange rate improves export prospects.	Apr.	+ 7%	Mar.	+11%	6.75%	.0587	Interest rates await fall in German rates.	Austria
Belgium	Economy weak, with industrial investment squeezed by overvalued currency and high interest rates.	Apr.	− 7%	118.9	+ 1.5%	May	6,876	+ 7%	1.2	0	Current-account gap expected to widen from 1980's $5.2 billion.	June	+ 7%	Dec.	+ 3%	13.00%	.0252	Rates vary inversely with franc pressures, but remain high.	Belgium
Britain	Recession now nearing its end, but recovery still some way off.	May	− 8%	518.7	− 1.2%	May	18,198	− 18%	2.0	512	All signs point to continuing external-accounts surplus.	May	+ 12%	Mar.	+ 8%	12.00%	1.8860	Recent pound weakness puts upward pressure on rates.	Britain
Denmark	Economic output continues to fall gradually.	Mar.	+ 4%	67.1	− 0.8%	May	2,601	+ 16%	1.7	0	High interest payments on foreign debt offsetting trade balance upturn.	Apr.	+ 12%	Dec.	+10%	11.00%	.1325	EMS membership keeps rates high.	Denmark
Finland	Economy slowing down gradually, but 1981 real growth still estimated at 2.5%.	Mar.	+ 1%	51.0	+ 6.0%	May	1,570	− 14%	1.3	78	Jan.-May current account posts fmk. 382-million surplus vs. deficit year ago.	Apr.	+ 12%	Nov.	+ 5%	9.25%	.2218	Rising inflationary pressures force tough monetary stance.	Finland
France	Business confidence remains low despite plans to reflate economy.	Apr.	− 8%	651.1	+ 1.2%	May	29,493	+ 15%	2.7	0	Trade gap may widen later in year as consumer spending picks up.	May	+ 13%	Feb.	+12%	9.50%	.1749	More stable exchange rate permits interest-rate easing.	France
Germany	Domestic demand remains flat; 1981 budget more expansionary than originally planned.	May	0	827.7	+ 1.8%	May	50,122	+ 4%	3.4	0	Export orders continue to surge in response to weak DM.	June	+ 6%	Apr.	+ 2%	7.50%	.4148	Interest rates await developments in U.S. credit markets.	Germany
Ireland	Real economic growth in 1981 not likely to exceed 1%.	Feb.	− 1%	17.6	+ 1.9%	May	2,304	+ 10%	2.5	0	Payments deficit expected to reach $619 million this year, 13% of GNP.	Feb.	+ 21%	May	+15%	14.40%	1.5000	Huge budget gap and weak currency keep rates high.	Ireland
Italy	Leading indicators point to renewed economic weakness, but inflation stays over 20%.	May	− 3%	394.9	+ 4.0%	May	15,999	− 28%	1.9	0	Trade deficit widening continues, with exports still weak.	June	+ 21%	Feb.	+15%	19.00%	.00083	Six-month import-deposit scheme introduced.	Italy
Netherlands	Domestic demand remains flat as inflation slows; no immediate prospect of reflation.	May	− 5%	160.8	+ 1.2%	May	9,315	− 9%	1.5	0	Current account posts IQ surplus of 1.4 billion guilders vs. deficit year ago.	May	+ 7%	Mar.	+ .4%	9.00%	.3738	Rates ease as guilder remains strong in EMS.	Netherlands
Norway	Oil output volume falling; GDP will likely show small decline this year.	Feb.	− 4%	56.7	+ 3.6%	May	6,386	+ 30%	4.5	0	Oil price cut will narrow IQ's current-account surplus of kr. 3.07 billion.	May	+ 14%	Jan.	+12%	9.00%	.1652	Rates high in face of 15% inflation rate.	Norway
Portugal	Official economic growth estimate for 1981 reduced to 2.9% from 5%.	Sept.	0	24.1	+ 3.9%	Apr.	476	− 16%	0.6	85	Bad weather may worsen payments balance despite good tourism prospects.	Apr.	+ 17%	Dec.	+13%	18.00%	.0158	Government planning tighter control of bank lending.	Portugal
Spain	Economy remains in recession with no sign of recovery.	Dec.	+ 5%	208.5	+ 0.5%	Apr.	10,520	− 9%	3.7	211	Weak peseta unlikely to improve poor payments-balance prospects.	Mar.	+ 16%	Mar.	+11%	8.00%	.010415	Domestic interest rates firm.	Spain
Sweden	All demand components except public consumption likely to fall in 1981, yielding 1% GDP decline.	Mar.	− 3%	124.3	+ 2.3%	May	4,131	+ 25%	1.7	0	Current-account deficit narrowing gradually; IQ gap was kr. 3.14 billion.	May	+ 15%	n. a.	—	12.00%	.1952	Domestic monetary policy remains restrictive.	Sweden
Switzerland	Slackening pace of economic activity continues past mid-year.	Dec.	+ 1%	99.8	+ 2.4%	May	10,436	− 13%	4.0	0	Reduced import volume narrows Jan.-May trade gap to $1.5 billion.	June	+ 6%	Mar.	− 2%	5.00%	.4835	No easing in central bank's tight money stance,	Switzerland
Turkey	Pick-up in economic activity fueled by greater import availability and reduced inflation.	n. a.	—	53.5	− 2.2%	Jan.	1,305	+121%	2.4	1,163	Favorable export showing in Jan.-Apr., but trade gap stays large.	Apr.	+ 37%	n. a.	—	—	.009955	Lira exchange rate now set on a daily basis.	Turkey
Canada	Industry output growing at 4% rate, led by manufacturing and retail sales.	May	0	246.5	+ 0.1%	May	2,322	− 28%	0.4	0	Trade surplus running at $7.2 billion annual rate.	May	+ 12%	June	+ 3%	19.09%	.8305	June M1 growth rate slowed to 2.5%.	Canada
United States	Economy on a flat-growth course, with tight money policy constraining spending.	June	+ 8%	2,626.5	− 0.1%	May	18,241	+ 70%	0.8	0	Lower oil imports offsetting export slackening.	May	+ 10%	June	+ 9%	14.00%	—	Money growth weak; business credit demands strong.	United States

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World Interest Rates

market rates of July 15, 1981; bond yields as of July 10, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	19.09	12.00	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	5.00	6.25
Day-to-Day Money	19.00 July 16	19.00	12.00	11.35	18.75	12.00	20.00	10.625	3.00	7.4375
Treasury Bills 91-day, Middle Rates	14.49 discount basis	18.80	12.9375	16.25	n. a.	n. a.	19.501 350-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	16.00 finance paper discount basis	19.10 finance paper 15% tax w/h	12.09	12.90 Certified	17.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.70	19.10 15% tax w/h	13.00	12.90 Certified	not traded	9.90	22.55	no market	10.00	no market
Government Bonds Long-term, new and old issues, average yield	13.54	16.25	14.77	10.465 20% tax w/h	16.575	10.47	20.40	11.53	5.53	8.14
Industrial Bonds prime, long-term, new and old issues, average yield	14.45 Aa Industrials	17.00	15.83	15.065	17.85	11.30	20.70	12.94	6.1125	7.23
Bank Short-Term Rate to Best Borrowers (prime rate)	20.50	20.00	13.00	18.00	19.60	14.50	22.50 ⅛ quar'ly fee on outstdng.	13.50	9.50	6.75
Bank Time Deposits 3-month	16.75 Cert. of Dep.	18.90	13.375	16.00	17.50	12.75	10.75	12.25 large deposits	9.50 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	18.00	no market	13.625	no market	23.50	12.4375	no market	12.25	9.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8305	1.8860	.0252	.1749	.4148	.00083	.3738	.4835	.004341
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.00 *D*	4.50 *P*	0.50 *D*	5.40 *D*	5.60 *P*	11.00 *D*	5.90 *P*	8.20 *P*	11.00 *P*

Eurodollar Deposits
(London, interbank, bid)
July 16

7-day	18.25
1-month	18.312
3-month	18.187
6-month	17.875

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.77
U.S.-Canada Treasury Bills	−2.22
U.S.-Canada Finance Co. Paper	−1.838
Eurodollars-U.K. Local Auth. Deposits	−0.1875

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	15.50
Over 7 yrs.	15.25
DM Bonds	
7 yrs. and under	11.375
Over 7 yrs.	10.50

Gold Price
London
afternoon fixing

412.24
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	9.8 (May)	12.3 (May)	11.7 (May)	12.7 (May)	5.5 (June)	20.6 (June)	6.4 (June)	5.4 (May)
Industrial production*	7.9 (June)	0.3 (May)	−8.0 (May)	−8.1 (Apr.)	0 (May)	−2.7 (May)	1.0 (Dec.)	−0.2 (May)
Trade balance† *(billions of local currency units)*	−$3.40 (May)	C$0.37 (May)	£0.31 (Feb.)	−FF3.34 (May)	DM1.57 (May)	−Lit.2,870 (May)	−SF0.72 (June)	¥190 (May)
Money supply (M1)*	8.5 (June)	3.0 (June)	7.6 (Mar.)	11.5 (Feb.)	1.5 (Apr.)	14.9 (Feb.)	−1.9 (Mar.)	−4.2 (Mar.)
Velocity of money (M1)*	12.9 (Mar.)	−0.14 (Dec.)	9.8 (Dec.)	n. a.	0.7 (Mar.)	6.7 (Dec.)	n. a.	10.5 (Dec.)
Reserves minus gold *($ million, change from previous month)*	−300 (May)	53 (May)	−2,073 (May)	−554 (May)	513 (May)	−1,603 (May)	−768 (May)	357 (May)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Assessing Eurocurrency Market Trends

The ability and efficiency with which the Eurocurrency markets adapt to changing financial conditions can be just as impressive in times of seemingly little stress as during times of crisis. In 1980, for example, the world oil market was relatively calm, particularly when compared with the sharp price rises that characterized the market in 1979, imposing lesser demands on the Eurocurrency markets. Indeed, by the end of 1980 the world was entering a sustained period of declining oil prices, easing considerably the current-account stresses of many countries. Nonetheless, there were many forces of change in international financial markets over the course of 1980, which the Euromarkets accommodated with efficiency and ease.

One of the major factors influencing world capital markets in 1980 was the volatile behavior of U.S. interest rates, characterized by not one, but two, major rate cycles. These rate cycles were the result of the Federal Reserve's switch to money-supply control via non-borrowed-reserve targeting and the Fed's difficulty in accomplishing its new tasks smoothly. The result was a period of relatively "tight" monetary conditions through the first quarter of 1980, followed by two quarters of relatively "loose" policy, with the year closing on a very "tight" note.

Despite these major fluctuations in U.S. interest rates and the fast growth in Euromarket lending that took place last year, "the rapid growth in the volume of international bank credit occurred without a general tightening of market conditions", according to the Bank for International Settlements (BIS). While interest rates in the United States and the dollar sector of the Eurocurrency market were certainly high by historical standards, contends the BIS, credit was plentiful at these rates and, significantly, Euroloan spreads were relatively narrow. Many borrowers in the Eurocurrency markets, however, took a different view. They saw high interest rates as an indication of tight market conditions.

This confusion in interpretation rests on more than conflicting definitions of what constitutes "tight" monetary conditions. Some analysts consider the existence of relatively high real interest rates as a measure of tightness. The BIS definition of tightness, however, is focused on the availability of credit at any price. In either case, a key to understanding how the Euromarkets react to high and variable dollar interest rates requires an understanding of the function of the two key prices that equilibrate the supply of and demand for credit in the Eurocurrency market. The two prices are the interest-rate level (e.g., London Interbank Offer Rate) and the spread over the standard interest rate (LIBOR or some other base rate).

Interest-rate levels for the various currencies in the Euromarkets are essentially determined in the respective domestic financial markets, with some feedback from worldwide markets. Dollar interest rates, for example, are determined in U.S. markets by the interaction of such influences as Federal Reserve policy and the market's inflation expectations. Whether resulting rate levels are high does not say anything about the availability of funds in the Euromarkets. The imposition of credit controls in the United States in the spring of 1980 caused "tight" monetary conditions in the classic sense, as some market participants (such as credit-card holders) were denied sources of credit even though they could and would have paid a higher price. But such tightness failed to carry over to the Euromarkets because such rationing of credit requires regulations that cannot be imposed on the Euromarkets.

The spread over the standard interest rate on Euroloans also has nothing to do with whether market conditions are tight or loose. It is determined by the interaction of competitive forces and reflects bank costs (interest and general operating expenses), borrower risk, and anticipated profits. Competitive conditions guarantee that the profit component will reflect only a reasonable return on capital, since other banks would be willing to accept lower spreads. Spreads, then, are independent of monetary conditions in the home currency country and are not a reflection of monetary policy. In 1980, the dominant factor affecting spreads was the risk assessment of major borrowers. In the past, and particularly in 1974 and in 1979, OPEC price hikes were the dominant cause of changes in risk assessments in the market. Oil price increases triggered severe current-account financing problems for many countries, and the subsequent ability of some countries to repay their commitments changed. In 1980, however, these considerations steadily diminished in importance. As a result, spreads were relatively narrow.

The actual impact of high and variable U.S. interest rates on the Eurocurrency market last year was limited to timing considerations on the part of borrowers. In the first quarter, there was a generalized sense that interest rates would decline later in the year and that borrowing should be postponed if at all possible. But during the second rate cycle, this expectation was less widely held and most borrowers tended to proceed with borrowings. Generally, Euromarket borrowing by countries with current-account financing needs is not particularly interest-rate sensi-

Assessing Eurocurrency Market Trends

(continued from page 7)

tive. This is because borrowers have few alternatives. The high and variable U.S. rates last year, for example, increased real returns in all dollar bond markets, and Eurobond markets are not a viable alternative source of funds for many developing countries. Thus, many countries with external-account financing requirements are tied to the Euromarkets for funding.

Although the world oil market was calm in 1980, imposing less demands on the Euromarket for current-account deficit financings, the markets witnessed shifts in OPEC behavior that tested their ability to reallocate funds among Eurobanks and to obtain new sources of funds. At the start of 1980, the OPEC countries were a principal source of new funds for the Eurocurrency market. By the end of the year, however, they were only a negligible source of new funds. This occurred for two main reasons: the OPEC members appeared to be favoring longer-term non-bank investments; and they were forced to increase their borrowings late in the year as their oil revenue growth came under increasing pressure. Furthermore, in the wake of the Iranian crisis, OPEC countries have tended to allocate new deposits to non-U.S. banks to a much greater degree than previously.

The reduced role of OPEC as a source of new funds for the Eurocurrency market occurred with little notice, owing largely to the efficiency of international arbitrage between dollar financial markets. Eurobanking depends heavily on the liquidity of the interbank market, and the ultimate source of funds is not important. The only possible impact is through changes in spreads among certain assets, as one set of investors may prefer one asset over another. Hence, the spread between Eurodollar time deposits and U.S. Treasury bills or U.S. commercial paper could be affected.

The second OPEC shift, that of an increasing preference for non-U.S. banks for new deposit placing, also had no effect on the market. Indeed, interbank markets were established for just this sort of accommodation. There were, however, some subtle impacts on banks. To the extent that a flow of new OPEC funds at interest rates a shade below interbank rates had been anticipated in the profit calculus of setting fees and spreads on lending, some U.S. banks may have suffered some weakening in their average cost positions—but not in their marginal cost positions.

In the absence of an OPEC price shock, Eurocurrency market trends are likely to continue responding to world growth and inflation patterns. The growth of the market (net size) may slow to less than 20% in 1981, compared with 22% growth last year, however, because of a reduction in U.S. and, thus, dollar inflation rates. (The Eurocurrency markets are measured in nominal terms so that any slowing of inflation is likely to be reflected in growth measures, real volume being held constant.) Inflation-adjusted lending is likely to grow by 8%-10% this year and in 1982, reflecting a rebound in world economic growth in late 1981 and in 1982.

Aside from growth trends, 1981 and 1982 will see increased experimentation with non-standard loan pricing and currency options. Some borrowers have obtained loans with spreads over U.S. bank prime rather than LIBOR. And these loans have captured the interest of U.S. regional banks. Also, more Special Drawing Right (SDR) loans are coming to the market. The new five-currency SDR basket is easily hedged for banks covering dollar funding risks, while the borrower may remain unhedged and take advantage of the interest-rate and exchange-rate diversification offered by SDR loans.

Bluford H. Putnam

Quarterly Euromarket Report

($ billion, end of period)

Total Market Size	**IQ/80**	**IIQ/80**	**IIIQ/80**	**IVQ/80**	**1979**	**1980**	**1981**
Gross Size (Claims)	1,117.4	1,206.0	1,247.9	1,323.1	1,110.7	1,323.1	1,550.0
Net Size (Claims)	680.0	745.0	775.0	810.0	665.0	810.0	950.0
U.S. Banks and Their Foreign Branches							
Total Liabilities to Foreigners	274.3	280.9	282.0	285.7	269.5	285.7	335.0
Liabilities to Private Nonbank Foreigners	67.7	69.8	72.1	74.7	65.9	74.7	86.0
Total Claims on Foreigners	324.8	347.3	365.0	382.1	324.0	382.1	440.0
Claims on Foreign Public Borrowers	40.9	41.5	46.1	48.6	42.0	48.6	54.0
Claims on Foreign Private Nonbank Borrowers	118.1	129.4	133.1	138.6	117.7	138.6	165.0

Note: Gross and net Eurocurrency market size definitions are those of the Bank for International Settlements (BIS). The difference between gross and net size is the interbank component. Net size includes transactions between banks in the Euromarket and: (a) official monetary authorities; (b) banks not participating in the Euromarket; and (c) nonbanks. U.S. bank and branch totals are net of transactions between parents and their foreign branches.

Source: Chase Manhattan Bank estimates based on BIS and national data sources.

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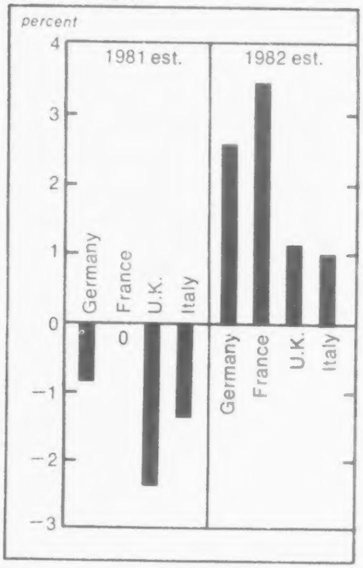
Waiting for the European Turnaround

European economic recovery has been delayed. Earlier this year it appeared that most European economies would have turned around by mid-summer. But mid-summer has arrived, and prospects now are that Europe as a whole will not show positive economic growth before the fourth quarter. The course of recovery from the current recession—now five quarters old—will be shallow in its initial stages, with the pace of growth not becoming robust much before next summer. Nonetheless, the below-trend increases in real output projected for 1982 on a year-over-year basis give something of a distorted picture. Measured from the fourth quarter of 1981 to fourth-quarter 1982, real output in Europe seems likely to increase at something like a 4% rate.

The major economies are relatively unsynchronized. France is widely expected to lead the rest of Europe, but the effects of the reflationary fiscal and wage policies of the Mitterrand government may prove to be largely offset in the short run by a plunge in business investment and further reductions in inventories. The outlook for Germany is even more uncertain. Foreign orders have surged since the autumn of 1980, and the growth of net exports has been sufficient to keep real GNP roughly stable over the first half of 1981 in spite of declines in virtually every component of real domestic demand. Nonetheless, inventories remain very high, private consumption demand is likely to be flat or declining in real terms through yearend, and construction remains extremely depressed. The U.K. growth outlook continues disappointing, although the long contraction of the British economy should come to an end this summer as inventory depletion ends. Italy appears likely to be the slowest to recover. The Italian economy is currently extremely weak because of the tight credit conditions made necessary by a worsened balance of payments earlier this year. Prospects for significant growth next year depend on a strong export recovery.

A major cause of this delay in recovery of the European economies is the restrictive monetary policies adopted by European monetary authorities in response to renewed dollar strength. Given the prospect of no relaxation in the current thrust of U.S. monetary policy—and the concern of most European policymakers with preventing a resurgence of inflation—a general shift to markedly more expansive policies in Europe does not appear likely next year. This implies that recovery in Europe will be relatively slow to acquire momentum. But it would also seem to imply that the recovery will be more durable.

European real GNP growth rates
(yearly averages)



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German trade balance poised for sharp upturn.

Germany's trade balance appears set for substantial improvement, with export orders surging and domestic orders remaining flat. The heightened competitiveness of exports stems from the decline in the mark's foreign-exchange value. The volume of export orders in April-May was up 22% from its cyclical low in August-September of last year, despite the continued weakness of Germany's major trading partners in the European Community. The improved order position has begun to translate into actual exports, with export volume in the first quarter of 1981 up 8%, on a seasonally adjusted quarterly basis. The seasonally adjusted trade balance showed a surplus of 2.6 billion DM in April-May, compared with a surplus of only 110 million DM in January-February and one of 1.2 billion DM in April-May 1980. As Germany publishes seasonally unadjusted trade and current-account numbers, data published in the next several months, reflecting seasonal outflows from expenditures on tourism, are likely to mask the extent of the underlying improvement and may delay a favorable reassessment of the mark by the world's foreign-exchange markets.

Italy's new government seeks public spending cuts.

Italy's new government has agreed to postpone spending of some 8 trillion lira to bring the public-sector borrowing requirement—now running at an annual rate of 50 trillion lira—nearer to its target of lit.37.5 trillion. Most of the postponed expenditures require parliamentary approval, however, which is uncertain. Italy's large budget deficit forces the Bank of Italy to choose between tightening credit to the private sector or allowing too rapid a rate of monetary expansion. So far, the central bank has leaned toward restricting private-sector credit, the latest evidence of which is a 30% import deposit scheme that requires importers to deposit 30% of the value of imports (excluding oil and wheat) interest-free with the Bank of Italy for three months. A large reduction in the public-sector borrowing requirement would permit some easing of credit to the private sector while maintaining money stock growth within acceptable limits.

Portugal adopts austerity policies to check a widening current-account gap.

A worsening balance-of-payments position is beginning to constrain Portuguese efforts to sustain an investment-led economic recovery. Official policies in 1980, a double election year, were basically successful, with real GDP growth of 5%, investment expansion of 8%, and a fall in the rate of inflation. The current account did, however, deteriorate, posting a deficit of $1.2 billion for the year. It has now become clear that expansionary policies cannot be sustained in 1981 with the world recession stifling export growth and a severe drought hampering both agricultural production and the output of hydroelectricity. Accordingly, to limit this year's current-account deficit to $1.7 billion, the government has put on the brakes. Spending by government departments and state enterprises has been cut, oil prices raised, interest rates increased for the first time in four years, and curbs placed upon foreign borrowing. The government does not, however, see these measures as representing a major setback to the new 1981-84 medium-term development plan.

Ecuador feeling the effects of weak world oil price.

Ecuador's oil export income in the first half of 1981 was down some 6% from its year-earlier level, owing to lower world oil prices. Crude export prices have fallen to $32 per barrel from $39 earlier this year. The fall in oil income is coinciding with weak prices and declining export revenue from Ecuador's other major commodity exports—bananas, coffee, cocoa, and sugar. Indeed, total exports for the January-June period were 8.5% below 1980, while imports were up 2%. The result is a less-than-anticipated level of foreign-exchange earnings—international reserves fell $260 million between end-1980 and May—and government budget income. This has prompted the government to reassess its financial and fiscal plans. Accordingly, government expenditure is being curtailed and more rigorous tax collection is being pressed. It is hoped that these adjustment actions will offset part of the loss of oil income.

Chile's exchange-rate policy brings lower inflation but a larger current-account deficit.

Chile has made remarkable progress on the inflation front since its adoption of a fixed exchange rate two years ago, but its current-account position has deteriorated. The consumer price index rose at an annual year-over-year rate of 21% in June, versus 38% in June 1980. If the small monthly increments in price rise registered in the first half are sustained, Chile's inflation rate will be less than 15% by yearend. The fixed-exchange-rate policy, however, has led to a significant rise in imports that has not been matched by a similar rise in exports. Indeed, in the January-April period, imports rose 47%; exports declined 16%, with mining export sales down 22%, owing to lower world mineral prices, and industrial product sales off 7% because of the reduced competitiveness associated with an appreciated real exchange rate. Based on this performance, Chile's current-account deficit is projected to widen to $3.2 billion in 1981 from $1.8 billion last year.

IMF steps up assistance to Thailand to help finance large and growing payments gap.

The new standby arrangement between Thailand and the IMF authorizes credits of 814.5 million SDRs ($925 million at the current exchange rate) to be drawn over a two-year period from mid-1981 to mid-1983. This precedent-setting figure is equivalent to 300% of the Thai quota of 271.5 million SDRs. Thailand's borrowings from the IMF have been rather small until now—obligations to the Fund in June were only SDR 109.1 million—but a widening balance-of-payments deficit has necessitated increased reliance on the IMF. Thailand's current-account deficit may exceed $3 billion this year, a result of rising oil prices, fiscal deficits, and inflation. The new IMF standby calls on the Thai government to take additional measures to boost energy prices, provide agricultural production incentives, and reduce the level of protection of certain industries. Since the standby's announcement, interest rates have been raised and the baht has been devalued 8.7%, measures undoubtedly supported by the IMF.

Papua New Guinea squeezed by weak commodity export prices and high imports.

The economy of Papua New Guinea is currently suffering the balance-of-payments maladies of all non-oil-exporting developing countries—export weakness coupled with rising import costs. The softness of world commodity prices led to a 2.1% drop in exports last year, in nominal terms, while imports soared 25.9%. The result was a deficit in goods and services of $423 million (some 16% of GDP), made up partly by Australian aid and by heavy commercial borrowing; $175 million in syndicated loans was raised in 1980-81. Given Papua New Guinea's vast mineral and agricultural resource potential—which underpinned these private credit extensions—its long-term economic prospects are undoubtedly bright. Short-term prospects, however, are less certain. The economy's performance in the short run depends on world commodity market conditions and on the timing and productivity of such investment projects as the Ok Tedi gold and copper mine currently under way. It also depends on whether the government decides to maintain the prevailing "hard kina" policy or replace it with a more flexible exchange policy to aid the trade balance.

Libya resisting substantive cuts in oil prices.

Libya, whose oil exports are traditionally the highest priced of any OPEC member, is facing increasing pressure to cut its official oil prices in view of the worldwide oil glut. On July 1, Libya reduced its official price by $1 per barrel to $40, the same as Algeria and Nigeria. But the $40 per-barrel price is still $5 above similar U.K. North Sea crudes and $8 above the Saudi benchmark price. As a result, oil companies have sought other sources of supply, causing Libya to reduce its production to one million barrels per day from the 1980 daily average of 1.8 million barrels. Libya's ambitious development program, however, is unlikely to be adversely affected. It is estimated that Libya needs the revenue from only one million barrels per day this year—some $13-$14 billion—to proceed with its development plans. And even in the event of an oil-revenue shortfall, Libya possesses reserves sufficient to cover a full year's foreign-exchange requirements.

Social Security: A Quick Fix or a Cure?

There is no denying that America's Social Security system is in trouble. Just how serious that trouble is now ranks as one of the most heated political issues in Washington. The outcome of the current debate will have profound implications for the system's survival—both in the short run and for the longer haul.

Much of the current controversy has focused on the impending threat to the system's financial viability. Social Security trustees have projected that unless steps are taken to change the current law, the Old Age and Survivors Insurance (OASI) Trust Fund—the largest of the three Social Security trust funds—will be exhausted in the latter half of 1982. Responding to this gloomy prediction, the Reagan administration has recommended the elimination of the so-called minimum benefit, as well as some other changes designed to curb system outflows, including a reduction in benefits paid those opting for early retirement. Opponents of the Reagan cost-cutting proposal have downplayed the significance of the depletion of the OASI Trust Fund. Using somewhat more optimistic economic assumptions, they argue that changing the law to allow borrowing from the other two trust funds would avert the short-term financial crisis until the scheduled 1985 tax increases begin replenishing reserves.

The short-term financial health of the Social Security system is indeed critical—not only to the millions of retired Americans who depend upon their monthly checks from the government's largest income transfer program, but also to the still-working generation now paying for those benefits. Decisions made now to shore up the ailing trust fund will determine whether Social Security will survive long enough for the younger workers to take advantage of it. Unfortunately, the policy response to the current crisis seems to be leaning in the direction of providing another short-term financial fix for the system, once again postponing consideration of the politically more difficult choices affecting the program's long-term viability.

To tackle Social Security's long-term ills, policymakers must first of all come to grips with the changing demographics underlying the system. Birth rates have been going down, while mortality rates continue to improve. According to current population projections, shortly after the turn of the century, as the post-World War II baby-boom generation starts to retire, the system will face its most severe crisis. Social Security analysts estimate that by 2025, there will be roughly only two workers paying into the system for every pensioner drawing benefits. This compares with the 16-to-1 ratio of workers to retirees in 1950 and the current ratio of about 3 to 1. This radical decline in the worker-to-beneficiary ratio means that to avoid the total collapse of the system in the next century, the architects of Social Security are faced with three basic alternatives: enacting another enormous payroll tax increase, finding some other means of funding old-age income security, or acting now to trim the growth of benefits.

Another large hike in payroll taxes seems unlikely. During the days of an expanding labor force, accompanied by healthy gains in productivity and strong income growth, modest tax increases to provide more generous benefits for the elderly went largely unnoticed. But the huge tax increase approved in 1977—the largest peacetime tax hike in U.S. history—was not well received by the American public. As provided by the 1977 law, scheduled tax increases throughout the 1980s and 1990s will boost not only payroll tax rates but also the maximum level up to which a worker's earnings can be taxed. Based on Social Security Administration projections, maximum employee contributions for Social Security (which are matched by employers) will go up by almost 77% over the next five years alone. The strong public protest elicited by the 1977 increase—which its proponents had promised would "guarantee" the financial solvency of the Social Security system through 2030—may indicate that the American taxpayer's tolerance for higher payroll taxes has neared its limit.

As for a new method of funding old-age income security, one of the more controversial ideas—yet one that has a fair amount of Congressional support—is to finance the retirement program with the general revenues of the U.S. Treasury. Opponents of such a recommendation fear that this would reduce all incentives to keep the system within some bounds of actuarial balance. Still, a number of economists have argued in favor of transferring to general budget financing only those Social-Security-provided benefits not related to an individual's work experience—Medicare hospital benefits, for example. This would bolster the long-term fiscal soundness of the system while better focusing it on what it was initially intended to do.

Despite the political debate spurred by the Reagan administration proposals, the time may now be right for consideration of the third basic avenue for reform: taking a close, careful look at Social Security benefits and the purposes they serve. A recent news poll reported that more persons now favor some reduction of benefits over another increase in payroll taxes as a means of saving the retirement system. One suggestion gaining increasing support is gradually boosting the age of eligibility for full retirement benefits to 68 from its present level of 65. Retirees and future retirees, however, deserve plenty of advance notice of any reforms that will directly affect the benefits they receive. This makes prompt action on the long-term problems of Social Security all the more critical.

Diana Bailey

Asia and Oceania

Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
													12-month changes				exchange rate in U.S. dollars	change from year earlier		
																	July 29, 1981			
			6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)			current monetary conditions	
Asia	Bangladesh	Political situation casts uncertainty over future direction of economic policy.	Dec.	+ 6%	12.5*	$ 138	May	235	— 15%	1.2	275	Large overhang of stocks, soft U.S. housing market depress jute prices.	Mar.	+12%	Feb.	+22%	.0630	—11%	Domestic credit likely to be curbed.	Bangladesh
	Burma	Favorable crops help government maintain nearly constant consumer price level.	Mar.	+ 22%	5.6*	174	May	267	— 5%	8.5	32	Record rice output estimated will boost exports.	Mar.	+ 0%	Sept.'79	+14%	.1350	—15%	Black market premium on kyat reported declining.	Burma
	China, People's Republic	Strong growth of light industry offsets decline in heavy industrial production.	June	+ 15%	517.0**	510	Dec.	2,527	— 5%	1.6	957	Despite machinery import cuts, first-half trade gap hit $500 million.	Dec.	+ 8%	n. a.	—	.5700	—16%	Treasury bonds sold to reduce money supply growth.	China, People's Republic
	Hong Kong	Stock market continues to advance, despite some slackening in industrial sector.	Mar.	+ 13%	20.8	4,105	n. a.	—	—	—	—	Export trends spotty; recession, currency movements hurt EC sales.	Mar.	+13%	Mar.	+17%	.1740	—14%	Rates rise one percentage point as HK dollar slips.	Hong Kong
	India	Aid donors pledge $3.45 billion for fiscal 1981-82.	Jan.	— 3%	172.6*	257	Jan.	6,995	— 8%	6.5	311	Wheat imports to resume as govt. domestic procurement falls below target.	Feb.	+13%	Sept.	+ 2%	.1125	—13%	Restrictive monetary measures taken to fight inflation.	India
	Indonesia	With surge in oil earnings, Pertamina launches huge refinery and petrochemical projects.	Nov.	+ 23%	63.2	417	May	6,165	+123%	6.7	0	Oil and gas output rising; export prices firm despite glut.	Apr.	+17%	Dec.	+46%	.001595	— 2%	Central bank continues heavy gold purchases.	Indonesia
	Japan	Momentum increasingly likely to come from domestic factors, especially consumer spending.	Apr.	+ 30%	1,043.8	8,938	May	27,283	+ 32%	2.2	0	Current account should deteriorate in second half as imports rise.	May	+ 5%	Mar.	— 4%	.004202	— 7%	Domestic factors preclude rate hikes despite weak yen.	Japan
	Korea	Slow but steady economic recovery proceeding, with export industries leading.	Apr.	+ 23%	57.8	1,513	Apr.	2,942	+ 17%	1.4	953	ASEAN tour by Chun may stimulate trade with Southeast Asia.	Apr.	+26%	Mar.	+20%	.0015	—12%	Won depreciation since end-1980 less than 4%.	Korea
	Malaysia	Most economic posts unchanged under new prime minister; policy shifts likely to be minor.	Jan.	— 1%	22.8	1,659	Mar.	4,204	+ 13%	4.4	0	Soft oil price, low prices for other exports narrow trade surplus.	Mar.	+ 9%	Mar.	+14%	.4245	— 9%	Ringgit remains firm through change of government.	Malaysia
	Pakistan	Real economic growth estimated at 5.7% in fiscal 1980-81.	Mar.	+ 22%	28.1*	351	May	1,021	+ 17%	2.3	518	Strong remittances held 1980-81 current-account gap near year-earlier level.	Mar.	+14%	Mar.	+15%	.1020	—30%	Deficit financing to be held to about 2% of GDP.	Pakistan
	Philippines	Government aid funds aid some distressed firms, but liquidity problems still widespread.	Feb.	+ 22%	35.9	750	May	2,449	+ 0%	3.7	826	Prices of main export commodities appear stabilized at low levels.	Apr.	+10%	Mar.	+10%	.1300	— 5%	Most interest rate ceilings lifted July 1.	Philippines
	Singapore	Policy of raising industrial wages will be eased this year.	Mar.	+ 18%	10.5	4,390	Feb.	6,787	+ 14%	3.1	0	New govt. investment corporation aims to boost earnings from reserves.	Apr.	+ 7%	Feb.	+ 5%	.4635	— 2%	Private credit demand strong; money growth rapid.	Singapore
	Sri Lanka	Power restrictions lifted with arrival of monsoon.	Dec.	+ 2%	4.1	279	Mar.	240	— 42%	1.4	227	SDR 37.5 million drawn under resumption of IMF Extended Fund Facility.	Apr.	+18%	Mar.	+21%	.0585	— 8%	Reserve requirements raised; credit restricted.	Sri Lanka
	Taiwan	Government continues efforts to attract high-technology, with slow results.	Mar.	+ 21%	40.2	2,278	n. a.	—	—	—	—	Exports slacken owing to revived Korean competition and European recession.	Mar.	+21%	Mar.	+14%	.0290	0	Use of bank loans for stock transactions prohibited.	Taiwan
	Thailand	New IMF standby agreement conditioned on more austere fiscal and monetary policies.	Mar.	+ 1%	32.2	693	May	1,236	— 42%	1.5	128	July 15 devaluation of 8.7% expected to spur exports.	Mar.	+15%	Dec.	+13%	.0475	— 6%	Bank loan ceiling lifted to 19% from 18%.	Thailand
Oceania	Australia	Sporadic labor strikes persist, constraining otherwise heated economy.	Apr.	+ 3%	137.7	9,360	May	2,864	+ 49%	1.5	72	Government liberalizes capital outflows to counter record inflows.	Mar.	+ 9%	Mar.	+11%	1.1395	— 1%	Capital inflows heighten inflationary pressures.	Australia
	New Zealand	Wages rising more rapidly than prices and productivity.	Mar.	+ 9%	21.2*	6,714	May	391	— 1%	0.9	108	Terms of trade decline.	Mar.	+15%	Mar.	+10%	.8320	—15%	Government actively taps Euromarket for funds.	New Zealand
	Papua New Guinea	Largest syndicated loan obtained on highly favorable terms.	Dec.	— 5%	2.2**	722	Mar.	350	— 29%	3.8	6	Weak commodity export prices generate current-account deficit.	Mar.	+11%	Mar.	—18%	n. a.	—	Prime rate raised two percentage points to 14.5%.	Papua New Guinea

*Fiscal year **1979

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World Interest Rates

market rates of July 29, 1981; bond yields as of July 24, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	19.89	12.00	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	5.00	6.25
Day-to-Day Money	17.75 July 30	20.00	12.75	7.65	18.125	12.00	20.00	1[illegible].50	1.00	7.375
Treasury Bills 91-day, Middle Rates	15.15 discount basis	20.875	13.75	16.25	n. a.	n. a.	18.451 92-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	16.75 finance paper discount basis	21.25 finance paper 15% tax w/h	12.949	12.90 Certified	17.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	17.25	21.25 15% tax w/h	13.9375	12.90 Certified	not traded	9.90	23.15	no market	9.625	no market
Government Bonds Long-term, new and old issues, average yield	13.84	17.50	14.85	11.135 20% tax w/h	n. a.	10.63	20.46	11.63	5.52	8.341
Industrial Bonds prime, long-term, new and old issues, average yield	14.60 Aa Industrials	18.25	16.02	16.95	n. a.	11.20	20.69	12.17	6.275	7.27
Bank Short-Term Rate to Best Borrowers (prime rate)	20.50	21.00	13.00	18.00	19.60	14.50	22.50 ⅛ quar'ly fee on outstdng.	14.00	9.50	6.75
Bank Time Deposits 3-month	17.625 Cert. of Dep.	20.30	14.375	15.50	17.50	12.75	10.75	13.50 large deposits	8.50 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	18.9375	no market	14.625	no market	22.375	12.75	no market	13.4375	9.8125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8147	1.8525	.0248	.1716	.4062	.00082	.3659	.4710	.004202
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.00 *D*	4.00 *P*	3.00 *D*	3.00 *D*	6.00 *P*	12.00 *D*	5.00 *P*	6.00 *P*	11.00 *P*

Eurodollar Deposits
(London, interbank, bid)
July 30

7-day	**19.00**
1-month	**19.00**
3-month	**19.00**
6-month	**18.875**

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	**−2.4114**
U.S.-Canada Treasury Bills	**−2.42**
U.S.-Canada Finance Co. Paper	**−2.208**
Eurodollars-U.K. Local Auth. Deposits	**n. a.**

Eurobonds
(average yield on recent straight debt issues)

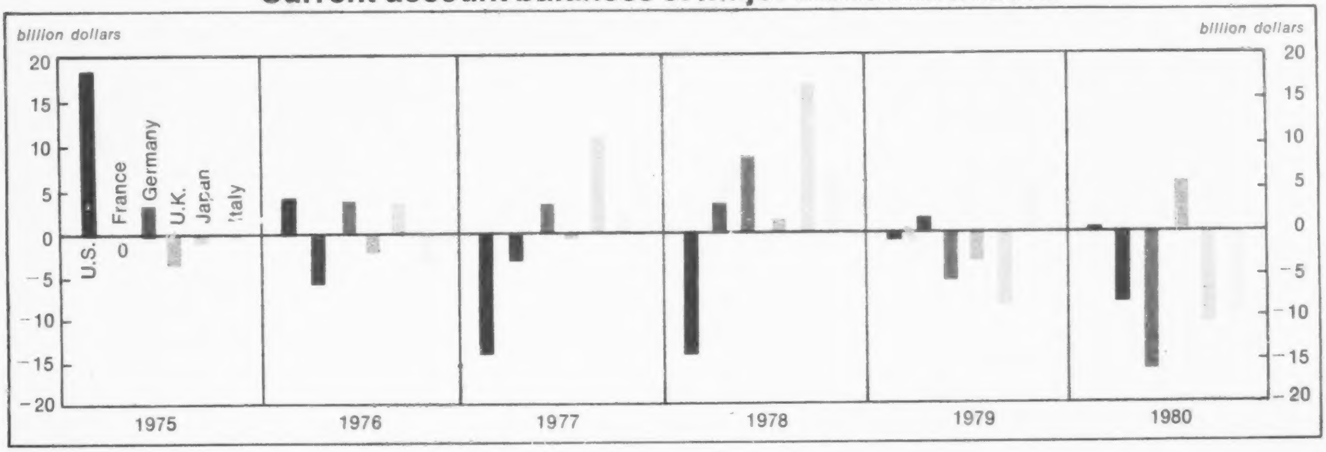
U.S. Dollar Bonds	
7 yrs. and under	**16.00**
Over 7 yrs.	**15.50**
DM Bonds	
7 yrs. and under	**11.50**
Over 7 yrs.	**10.625**

Gold Price
London
afternoon fixing

402.25*
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* July 30.

Current account balances of major industrial nations



U.K. Revising Monetary Control Techniques

The Bank of England has recently announced proposals to change some of the rules governing the operations of the London money markets and of the 500 or so banks participating in them. Changes in money-market rules are significant for their relative rarity and for their wide-reaching and sometimes unforeseen effects. The latest proposals are essentially an acknowledgement of the U.K. monetary authorities' problems with controlling the money supply—an objective that has assumed great importance under the leadership of Prime Minister Thatcher.

The Bank of England's decision to alter U.K. money-market rules must take many variables into account—including its sometimes conflicting mandates. First, the bank must fulfill its role as the guardian of the financial system, ensuring that institutions operating in the market are properly managed and observe sensible guidelines to limit their risks. Second, the bank must serve as banker to the British government and must ensure that the government's very large financing needs (the budget deficit is now running at 7% of GNP) are met on favorable terms. And third, the central bank has to implement the government's monetary policies.

Very often these three central bank roles tend to conflict, necessitating a compromise in terms of money-market rules. For example, a tightening of monetary conditions may curb the London market's appetite for government paper, which increases the government's difficulty in financing the deficit. Also, tight monetary polices may mean high interest rates, which increase the cost of servicing the government's debt and raise its borrowing requirement.

The stock of money is usually measured by sterling M3, defined as cash in circulation plus the sterling bank deposits of all U.K residents. Sterling M3 has consistently grown faster than government intentions, despite large rises in interest rates and, at times, quantitative controls on banks. The central bank was thus faced with two alternatives in redesigning money-market rules: to seek better ways of controlling sterling M3 and/or to reexamine theory and practice to determine whether sterling M3 is an appropriate measure of the money supply.

There is certainly a strong case for choosing another money-supply measure. Sterling M3 was well above its target range in 1980, even though the British economy showed many signs of tight money. Nominal interest rates were high, the exchange rate appreciated sharply, and—given the inflexibility of wages—output fell below its 1979 level. Indeed, some of the other measures of the money stock—both broader and narrower—grew much less rapidly than sterling M3, which has led many observers to call for a different measure.

Also casting doubt on the validity of such traditional money-stock measures as sterling M3 are developments that have superseded the suspension of foreign-exchange controls in November 1979. Since the suspension, British residents have been free to export sterling, to buy assets abroad, and to hold foreign currencies. Recent statistics show that, as a result, there has been a large increase in residents' holdings of foreign currencies. Such holdings, however, are not included in sterling M3.

Further complicating matters has been the severity of the recession in the United Kingdom, which has reduced the government's tax revenue well below its planned figure while increasing its expenditure on social security payments as well as its subsidies to the nationalized industries. As a result, the expanding budget deficit and its financing problems are compounding the difficulty of controlling money growth.

It is against this background that the Bank of England issued consultative documents proposing changes in money-market rules. In light of the market's reactions to these documents, details have been refined and the market now awaits the new rules' implementation. The new guidelines are widely expected to become effective on August 20, but it is still possible that the current proposals will be modified or that implementation of some or all parts will be postponed.

Many of the consultative papers published by the central bank deal with the management of foreign-currency exposure—an area that has become more important since the suspension of exchange controls. The changes in the rules pertaining to foreign-currency exposure will be important to the management of the banks in London, but they are unlikely to mean any great changes for monetary conditions and, hence, for the behavior of interest rates and the sterling exchange rate. Of greater importance to the international marketplace will be the changes that are proposed in the techniques of monetary control.

New control techniques explained

The discussion of methods of monetary control in the United Kingdom has centered on the money-stock measure to be used in targeting money growth and on the best techniques to be used to control the chosen measure. On the first issue, the central bank has reaffirmed that sterling M3 will remain the prime tool of monetary policy, but that account will be taken of other aggregates as well. Thus, the course of M1 and M3 (equal to sterling M3 plus U.K. residents' foreign-currency deposits at banks) will continue to be watched closely. In addition, the central bank has

U.K. Revising Monetary Control Techniques

(continued from page 7)

introduced two new measures that provide more details of private-sector liquidity: PSL1, defined as the private-sector component of sterling M3 plus holdings of other money-market instruments, such as deposits with local authorities and finance houses and certificates of tax deposits; and PSL2, defined as PSL1 plus private-sector savings deposits with such institutions as building societies and savings banks. These various measures often move in different directions, so that by focusing its attention on one rather than another, the central bank can have considerable freedom of action.

As for better controlling the chosen money-stock measure, the Bank of England has made it clear that, beginning in August, it intends to operate on the monetary base (banks' deposits with the Bank of England) as a means of controlling the important aggregates. So far, the central bank has backed away from an entirely mandatory system under which banks must follow clear-cut rules. It is suggested only that all banks deposit ½% of their liabilities as cash balances at the Bank of England while leaving banks to make their own decisions on many of the assets that they hold against their liabilities. (However, many observers expect an announcement very soon that all banks must also deposit 6% of their eligible liabilities with the discount houses.)

As for its own strategy, the central bank proposes to make several alterations in its day-to-day operations. Greater emphasis will be placed on open-market operations at the expense of discount-window (lender-of-last-resort) lending. The open-market operations will aim to keep very short-term interest rates within a band determined by the authorities' monetary objectives. The upper and lower limits of the band would not be published, but the central bank would hint at them by charging a rate on its discount-window lending somewhat above comparable market rates but still within the unpublished band. At some stage, the central bank would probably stop announcing a Minimum Lending Rate (the old "bank rate"), as it would have no particular significance.

Assessing the impact

It appears virtually certain that during the initial stages, interest rates and sterling's exchange rate will be more volatile than previously as a result of the new changes. This is because the Bank of England will have to learn as it goes along, but, more important, it is because a lot of "central-bank-watching" is likely to emerge as the market searches for clues about the bank's day-to-day intentions. As in the United States, excessive attention will probably be given to short-term fluctuations, triggering gross over-reactions by the market. Given the present weakness of sterling and the uncertainty over government policy, it appears likely that the first of the volatile movements will see interest rates climb rather than drop.

Over the longer run, the practical effects of the changes are likely to be smaller than a theoretical presentation would suggest. It is clear that no government can set independent targets for the growth of nominal GNP, for the growth of the money stock, and for the structure of interest rates—as has been demonstrated by recent U.S. experience. It follows that if the authorities stick rigidly to a desired growth of GNP and the money stock, they are forced to allow interest rates to move to market-clearing levels. The British government, however, has found that when it has tried to control the growth of the money stock, the market-clearing interest-rate levels tend to be higher than it can accept. This is partly because of political considerations but also because the resulting levels are incompatible with other components of economic policy, such as management of the government debt and the exchange rate. Thus, a compromise is often reached whereby the money stock is allowed to overshoot and the rise in interest rates is checked. The overshooting has sometimes been quite overt; at other times, the authorities have imposed quantitative controls—such as the "corset" mechanism—that artificially depress the chosen money-stock measure relative to other measures and so disguise the extent to which overshooting is actually occurring.

This process is very likely to continue under the new regime. The Bank of England has deliberately left its proposals riddled with loopholes. It has chosen to allow banks to make their own decisions about the *prudent* level of reserves, so that the size—of the stability—of the money multiplier cannot be predicted in advance. In addition, the monetary authorities have indicated not only that they will watch more than one money-stock measure, but also that they may change at any time the relative weights they attach to each. Thus, an overshooting in one or more measures may or may not be a signal that conditions in the money markets are about to be changed. Finally, by refusing to publish its target interest-rate band and allowing itself to charge a rate at its discount window anywhere within the band, the central bank will avoid giving any clear indication of its views on the existing level of interest rates.

In sum, there is likely to be little substantive change in money market trends as a result of the new measures. Increased volatility around those trends can be expected, however, and this implies a higher risk for market participants that may require compensation in the form of somewhat higher average real interest rates.

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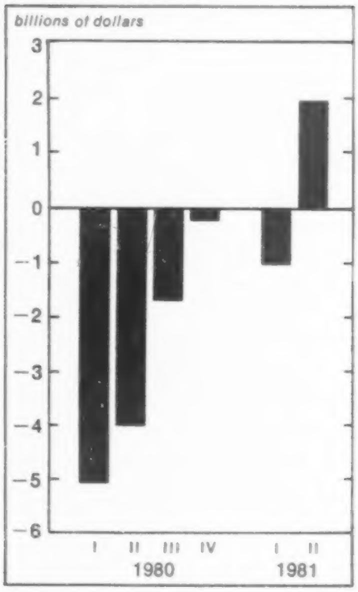
Japanese Exports to Continue to Fuel Growth

The Japanese authorities are beginning to show concern about the slow recovery of the domestic economy. The government had been counting on a pickup in domestic demand to provide a strong impetus to growth and to alleviate some of the pressure to export. However, so far this year most of the momentum for growth has come from net exports. Housing remains extremely depressed, and private plant and equipment investment, particularly by smaller firms, appears to be slowing. Private consumption spending has shown some revival recently, with the 7.7% average wage increase resulting from this spring's labor negotiations and the moderation of consumer price inflation to just over 5%. Nevertheless, consumer spending remains relatively sluggish.

Japan's current account performance
(seasonally adjusted)



Concerned that the economy's continued reliance on external demand will provoke sharp foreign reaction, the Economic Planning Agency and the Ministry for International Trade and Industry are reportedly pushing for a new package of measures to stimulate the domestic economy and boost imports. The measures available to the Japanese government are quite limited, however. High U.S. interest rates and an already-weak yen preclude a cut in the discount rate, and fiscal stimulation is limited by the government's desire to reduce the budget deficit. Subsidies in support of $3 billion of emergency imports, an acceleration in public-works spending, and a relaxation of conditions for public housing financing have been proposed. But any measures taken are likely to have relatively little impact.

Despite any initiatives to spur a pickup in the domestic economy and imports, Japan's balance-of-payments showing is likely to draw renewed criticism from its trading partners. Exports have continued to surge—led by color television sets and videotape recorders—while imports, particularly of oil, have been soft because of the weakness of the domestic economy. For the first six months of 1981, Japan recorded a seasonally adjusted current-account surplus of $1 billion. Although exports may slow and imports may accelerate in the second half of the year, the current account for 1981 as a whole could register a surplus of $2 billion, a sharp turnaround from the deficit of $10.8 billion in 1980. And with a recovery in the world economy, the recent depreciation of the yen against the dollar, and the strong non-price competitiveness of Japan's export products, Japan may be poised for an export boom that could push the current-account surplus to the $5-$10 billion range next year.

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Sterling weakness threatens to undermine U.K. progress on inflation.

The U.K. economy appears to be signaling an end to the recessionary slide. Retail sales volume is up 10% over last year, and the June industrial production index posted its first significant climb in many months (1%). Even unemployment, up to 10.7%, is now rising only slowly. These encouraging signs, however, are being overshadowed by sterling's weakness, which, combined with the dollar's strength, has seen the pound's exchange rate fall back down to its 1977 levels. Sterling weakness threatens to undermine the recession-induced declines in inflation because raw material prices are now rising fast in sterling terms, and British firms, with profits already squeezed, will have no choice but to pass on price increases. The government has been unwilling to defend sterling by boosting interest rates, and U.K. ministers have been stressing the need for moderate wage settlements in the new pay round that began in July. The prospective inflationary pressure is causing growing concern that the United Kingdom, currently paying the short-term cost of Mrs. Thatcher's policies, may fail to enjoy the long-term benefits.

Norway's oil boom has negative consequences for inflation and competitiveness.

Norway's developing oil sector has continued to put inflationary pressure on the domestic economy. Wages in the oil sector have been bid up to attract scarce labor, and the non-oil sector has responded by raising its own wages, thereby increasing costs and further reducing competitiveness. The exchange rate provides little relief since the kroner remains in demand because of Norway's rising oil production and continued high oil prices. The heightened pressure is showing up in the consumer price index, which has climbed rapidly this year to reach a year-over-year increase of 13.9% in June and 14.2% in July. The July figure was sufficiently large to trigger wage increases under Norway's indexation system agreed on between labor and management. But just before the wage rises were to be announced, the minority labor government—which faces an election on September 14—put a freeze on domestic prices and wages through yearend. Unless efforts are made to deal with the underlying causes of inflation, however, the rate of price rise is likely to accelerate once the freeze is lifted--as happened when the last 15-month freeze ended in January 1980. With the upcoming election almost certain to fail to give any party the large majority needed to implement effective anti-inflation policies, the prospects for Norwegian inflation and competitiveness are uncertain. What is likely is that the next administration will opt for a creative shift in policy that would allow Norway to take fuller advantage of its new-found oil wealth.

Uruguay faced with challenges to rapid growth and reserves position.

With the exception of 1979, real economic growth in Uruguay has averaged a healthy 4% per annum since 1977—much greater than the population growth rate of less than 1%. And more recently, progress on inflation has seen the year-over-year rate brought down from an average 65% per annum in 1979-80 to 35% this past June. The current-account deficit has widened markedly, to $480 million in 1980 from $126 million in 1978, however, reflecting an import liberalization policy and an overvalued exchange rate. But capital inflows have more than met the country's financial requirements, allowing gross international reserves to rise rapidly, to $530 million from $290 million at end-1978. Developments both on the internal political and external fronts, however, pose potential obstacles to continued progress. These include the transfer of power to a new president in September and the economic instability in Argentina, upon which Uruguay is heavily dependent for exports, tourism, and capital.

Taiwanese currency's link with U.S. dollar prompts a devaluation.

Responding to the reduced price competitiveness of its exports, Taiwan's central bank devalued the New Taiwan dollar by about 4.8% on August 12. The Taiwanese currency, which is pegged to the U.S. currency and has remained stable in U.S. dollar terms since the early 1960s, fell from 36.24 per U.S. dollar to about 38.00 The move was aimed largely at offsetting the reduced price competitiveness of exports to Europe and Japan brought about by the U.S. dollar's appreciation. Taiwanese exports have been reasonably strong in 1981, totaling $12.8 billion for the first seven months—16.1% above the year-earlier figure. Imports during the same period totaled $12.9 billion, up 12.6%. The recent devaluation of the Thai baht and the depreciation in U.S. dollar terms of several other Asian currencies, however, probably convinced the authorities that a move was necessary. The degree of devaluation is modest considering the extent to which the U.S. dollar peg had appreciated Taiwan's currency relative to those of other OECD countries. It undoubtedly represents a compromise between exporters who sought a devaluation of 10% or more and the conservative monetary authorities.

Sri Lanka under IMF pressure to devalue.

The IMF is apparently pressing Sri Lanka to devalue the rupee by 10% as a condition for receiving the final tranche of a SDR 260-million Extended Fund Facility loan. Sri Lanka's domestic prices in recent years have risen more rapidly than international prices, and the movement of the exchange rate has failed to compensate for the differential. As a result, it is increasingly difficult for domestic producers either to export or compete with imports. The current-account deficit, reflecting this, nearly tripled to $667 million in 1980. So far this year, the monetary authorities have allowed the rupee to slip over 9% against the dollar. Nevertheless, because of the dollar's strong appreciation against the European currencies, the rupee has appreciated against the currencies of many of its major trading partners. If the U.S. dollar remains relatively strong—as is expected—the prospects for Sri Lanka's exports and imports will be unfavorable without an accelerated depreciation of the rupee.

Australia's new wage policy implies upward wage pressure.

Amidst widespread labor strikes, the Australian government has abandoned its six-year old centralized wage-fixing system, whereby pay increases were partially indexed to the rate of inflation. The labor market will thus resort to free collective bargaining, although the Arbitration Commission may continue to supervise bargaining and disputes. The abandonment of the wage-fixing system and the recent labor turmoil are the result of a combination of the country's booming economy, led by natural resource development, with the rigidities of the old centralized wage-fixing system. The former system hindered labor mobility between sectors because it could not accommodate the high wage demands of skilled workers created by the resource boom without granting similar increases in low-demand nonresource sectors. The result was a shortage of skilled labor and persistently high unemployment in nonresource sectors. The authorities are hoping that these imbalances will be redressed with free wage bargaining. But heightened expectations suggest strong upward wage pressures. The government is expected to resist with tight fiscal and monetary policies, which should greatly affect Australia's economic performance in the coming year.

Syrian parallel exchange-rate scheme meets with initial success.

In an effort to increase the supply of foreign exchange and eliminate a currency black market, Syria's government recently introduced a number of measures. A parallel flexible-rate foreign-exchange market was established for all private-sector transactions and a few public-sector exports. The parallel rate initially set by the Commercial Bank of Syria was 6.30 Syrian pounds to the U.S. dollar, a 38% devaluation over the official rate of 3.925 pounds per dollar. The aim was to give Syrian workers abroad a greater incentive to channel their remittances through the Syrian banking system and encourage Syrian producers to expand exports. The scheme appears to have had some success to date, with the parallel rate appreciating to about U.S.$1 = S.£5.00. Meanwhile, both the Syrian Cabinet and Party Central Committee have approved the long-awaited 1981-85 five-year plan. The plan is expected to stress the completion of current projects and give higher priority to light industry and agriculture.

Investment: Tax Incentives Not Enough

With final Congressional approval and President Reagan's signing of the Economic Recovery Tax Act of 1981 earlier this month, advocates of supply-side economics won a notable victory. Contained in the new tax law are a number of measures designed to stimulate capital investment—a key priority of the Reagan administration's supply-oriented strategy to shore up economic growth in the United States and revitalize American productivity. Among the provisions highly favorable to future investment are:

- accelerated depreciation of business structures and capital equipment,
- a reduction in the top tax rate on "unearned," or investment, income to 50% from 70%, and
- a lowering of the maximum tax rate on capital gains to 20% from 28%.

Supply-siders assert that these changes in the tax law are critical to promoting new capital formation. And indeed, they may be. Nevertheless, it is unlikely that the new tax incentives will have a noticeable impact on business investment in new plant and equipment in the near term. This is because the current weakness in investment spending is more the result of other considerations.

Most significant is the lack of vigor in overall demand. Industrial operating rates—a rough measure of the portion of existing productive capacity currently in use—have been close to 80% for months and have recently fallen below that level. In the past, operating rates have had to move above 85% before they triggered a major expansion of capital spending. Other critical influences on business investment decisions have been the persistence of high interest rates and uncertainty over the future course of inflation.

Over the next few months, interest rates are expected to come down—but not by very much. And inflation, despite a mid-summer spurt, is expected to ease through the end of 1981. But more important, the industrial operating rate should improve slowly after a few more months of economic stagnation. The combination of these changes should be sufficient to start business investment moving upward by the beginning of next year. Nonetheless, investment in 1982 is likely to grow by only about 4% in real terms.

Thus, it appears that supply-siders will have to ride out the business cycle for a while before their theories on taxes and investment can really be tested. Investment growth is not likely to be rapid until the operating rates approach the trigger point. But if the economy regains strength and continues to expand through 1983, the stage will be set for a major investment boom—with the recently enacted tax incentive serving as catalyst.

The Loose Link Between Money and GNP

The money supply this year has seemed to move almost independently of changes in the aggregate demand for goods and services, even on a monthly and quarterly basis. Put another way, perfect foresight of the behavior of GNP this year would have been of little use to money-supply forecasters. This is especially disconcerting in an environment in which short-run movements in money growth play a major role in monetary policy actions.

For example, in the first quarter of this year, current-dollar GNP rose at an annual rate of 19%, while M1-B (adjusted for the estimated effects of shifts into NOW accounts) fell at an annual rate of 1%. And in the second quarter, GNP increased by only 4%, while adjusted M1-B rose by 5½%. Such behavior is inconsistent with historical relationships among M1-B, GNP, and interest rates. Some observers contend that a downward "shift" in the demand for money has occurred, probably in response to high interest rates.

There are other forces, however, that can cause the short-run relationship between money and GNP to be highly volatile. For one, the relationship between money and income may be of the "lead-lag" variety, rather than contemporaneous. However, any such lead-lag relationships have not been stable recently.

Another such force concerns the adjustments for seasonal variations made to the money supply and to various measures of income and sales. It is widely recognized that the method used to adjust the money supply for seasonal changes is imperfect. Furthermore, the method used to adjust various measures of income and sales differs significantly from that used to adjust the money supply. Both of these forces have affected the behavior of M1-B relative to income this year.

The behavior of bank loans relative to income can also affect the money/income relationship. Such an effect is difficult to quantify, however, since the relationship between money and bank loans is often temporary, and depends on the extent to which changes in loan growth are related to changes in sales.

Finally, the relationship between GNP and total transactions, which some economists believe are a determinant of the demand for money, is often quite loose in the short run. For example, in the first half of this year total business sales—which include intermediate transactions not included in GNP but which must be financed—were much weaker than GNP.

In sum, there are other forces besides "shifts" in the demand for money that can cause substantial short-run variations in the relationship between seasonally adjusted money and income. Unfortunately, determining the cause of any such variations—especially on a contemporaneous basis—is extremely difficult. Of course, these variations may "wash out" over the long run. But in the short run they can have major effects on the course of monetary policy and interest rates, and thus contribute to the uncertainty plaguing financial markets.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes							
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars August 26, 1981	change from year earlier	current monetary conditions	
Argentina	New government program will refinance half of private manufacturing industry debts.	Mar.	— 8%	117.0	$4,333	Apr.	5,203	— 42%	6.4	0	Exchange rates stabilizing after recent devaluations.	July	+105%	Dec.	+ 95%	.00016	—68%	Money supply (M1) falls in first four months of 1981.	**Argentina**
Bahamas	Construction activity rising, paced by government's $150-million hotel expansion program.	Mar.	— 9%	1.2	5,630	June	117	+ 15%	1.4	0	Capital account improving.	April	+ 13%	Mar.	+ 2%	1.0050	+ 3%	Building and construction credit increases.	**Bahamas**
Bolivia	Economic activity continues to deteriorate.	Dec.	+ 21%	6.1	1,100	May	111	+ 26%	1.5	73	Exchange controls imposed to stem capital flight.	Mar.	+ 36%	Apr.	+ 22%	.0409	+ 5%	Net international reserves falling.	**Bolivia**
Brazil	Industrial sector in recession, but rate of inflation has declined sharply.	June	+ 18%	237.2	1,931	June	5,200	— 8%	2.6	0	Second monthly trade surplus posted in June.	July	+111%	June	+ 56%	.0098	—45%	Money supply reduction on target.	**Brazil**
Chile	Industrial growth was a slight 2.6% in first quarter, but inflation rate rose only 5.4% in first half.	June	— 15%	22.8	2,060	June	3,248	+ 25%	5.8	80	January-June exports down 15%, imports up 41% from year earlier.	June	+ 21%	Dec.	+ 58%	.0260	0	Domestic liquidity tight.	**Chile**
Colombia	Strong import competition contributing to industrial slowdown, especially in textiles, shoes, and plastics.	Mar.	— 31%	36.8	1,360	June	4,609	+ 13%	10.5	0	Reserves decline as coffee income drops.	May	+ 26%	Dec.	+ 28%	.0195	—11%	Bank credit expansion accelerates.	**Colombia**
Costa Rica	Domestic economic activity decelerating owing to tighter fiscal and credit policies.	May	0	5.0	2,190	June	183	+ 53%	1.6	106	Authorities planning to restructure $2-billion external debt.	May	+ 30%	Dec.	+ 17%	.0590	—50%	Monetary policy restrictive.	**Costa Rica**
Dominican Republic	Economic growth expected to slow in light of efforts to curb external imbalance.	Mar.	— 4%	6.9	1,280	June	191	+ 15%	1.3	29	Restrictive measures should cut import spending.	Feb.	+ 9%	Mar.	— 3%	Par	—	Liquidity tight.	**Dominican Republic**
Ecuador	Public spending restrained to offset decline of petroleum export earnings.	May	— 9%	11.0	1,321	June	756	— 13%	4.3	0	Import duties increased on 535 items for revenue purposes.	May	+ 16%	June	+ 22%	.0360	— 3%	Bank deposits increase after early 1981 dip.	**Ecuador**
Guyana	IMF approves increase in Extended Fund Facility up to 400% of Guyana's quota.	Dec.	+ 33%	0.5	550	June	22	+ 5%	0.9	71	Currency devalued 15% to aid exports.	Dec.	+ 8%	Feb.	+ 1%	.4000	+ 2%	Credit curtailed as public spending is cut.	**Guyana**
Honduras	Real GDP grew 2% in 1980 versus 7% in 1979; slower growth expected this year.	Feb.	— 9%	2.4	658	Jan.	138	— 33%	1.7	14	New 10% surcharge put on imports, including those from Central America.	Oct.	+ 15%	Apr.	— 3%	.5000	0	Net foreign assets down.	**Honduras**
Jamaica	Alcoa and Alcan cutback in aluminum output will erode 12% advance in first quarter.	Feb.	+ 27%	3.2	1,460	June	104	— 15%	1.0	377	Imports up 20% in Jan.-Feb., with exports rising 18%.	Jan.	+ 24%	Feb.	+ 13%	.5618	0	Credit availability limited.	**Jamaica**
Mexico	Shipments of interrupted oil exports are resuming at average price of $30.70 per barrel.	Apr.	+ 58%	167.0	2,300	Jan.	2,918	+ 32%	1.5	0	Import licensing stepped up to cut foreign-goods demand.	July	+ 27%	May	+ 41%	.0403	0	Government treasury financing operations increase.	**Mexico**
Panama	Manufacturing and construction sectors advance briskly but unemployment still troublesome.	Mar.	+ 22%	3.5	1,805	June	93	— 51%	0.7	29	Large increase in refined oil exports recorded.	Apr.	+ 8%	Dec.	+ 10%	Par	—	Construction loans grow rapidly.	**Panama**
Paraguay	Plans under study for utilization of hydroelectric power from Itaipu project.	Apr.	+ 38%	4.6	1,505	June	799	+ 17%	15.4	0	Soybean exports increase significantly.	Feb.	+ 19%	Dec.	+ 26%	.0080	0	Credit demand strong.	**Paraguay**
Peru	General wage rise of 10% mandated for public and non-union private-sector workers.	May	— 16%	17.2	965	Feb.	1,756	+ 26%	7.5	399	Additional import duties lowered, bringing average tariff to 32%.	June	+ 82%	June	+ 47%	.0024	—31%	Domestic credit rising sharply.	**Peru**
Uruguay	CPI rose 14.5% in first half, compared with 21% during first-half 1980.	Apr.	+ 62%	9.8	3,825	Apr.	596	+ 30%	4.3	0	Exports up 62% in first four months, while imports fell 6%.	June	+ 35%	Sept.	+ 32%	.0950	—14%	Interest rates declining.	**Uruguay**
Venezuela	Legislation allowing resumed medium-term borrowing in Eurocredit market progressing.	Feb.	+ 20%	51.4	3,690	June	8,913	+ 33%	9.8	0	Capital outflow prompted by low interest rates.	May	+ 18%	Mar.	+ 27%	.2328	0	Credit availability limited.	**Venezuela**

World Interest Rates

market rates of August 26, 1981; bond yields as of August 21, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	21.03	12.00	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	5.00	6.25
Day-to-Day Money	17.00 Aug. 27	23.00	12.75	12.15	17.50	12.00	20.125	13.375	2.50	7.375
Treasury Bills 91-day, Middle Rates	15.85 discount basis	20.90	13.25	15.75	n. a.	n. a.	19.086 92-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	17.25 finance paper discount basis	22.00 finance paper 15% tax w/h	12.52	12.90 Certified	17.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	17.30	21.90 15% tax w/h	13.25	12.90 Certified	not traded	9.90	22.70	no market	9.25	no market
Government Bonds Long-term, new and old issues, average yield	14.51	17.00	14.60	11.302 20% tax w/h	16.43	10.78	20.81	12.22	5.72	8.62
Industrial Bonds prime, long-term, new and old issues, average yield	15.55 Aa Industrials	18.125	15.86	17.395	17.75	11.56	21.09	13.55	6.39	7.23
Bank Short-Term Rate to Best Borrowers (prime rate)	20.50	22.75	14.00	18.00	18.50	14.50	22.50 ⅛ quar'ly fee on outstdng.	15.00	9.50	6.75
Bank Time Deposits 3-month	17.75 Cert. of Dep.	21.75	13.9375	15.30	17.75	12.65	10.75	13.75 large deposits	8.50 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	19.25	no market	14.00	no market	28.25	12.6875	no market	13.875	9.375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8235	1.8425	.0248	.1688	.4036	.00081	.3633	.4648	.00434
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.00 *D*	5.00 *P*	2.00 *D*	9.00 *D*	6.00 *P*	15.50 *D*	5.00 *P*	10.00 *P*	11.00 *P*

Eurodollar Deposits
(London, interbank, bid)
Aug. 27

7-day	18.0625
1-month	18.50
3-month	19.00
6-month	19.00

International Arbitrage
(3-month, hedged) **+** *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.218
U.S.-Canada Treasury Bills	−0.743
U.S.-Canada Finance Co. Paper	−1.448
Eurodollars-U.K. Local Auth. Deposits	+0.063

Eurobonds
(average yield on recent straight debt issues)*

U.S. Dollar Bonds	
7 yrs. and under	16.18
Over 7 yrs.	15.89
DM Bonds	
7 yrs. and under	11.25
Over 7 yrs.	10.765

Gold Price
London
afternoon fixing

414.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Yields as of August 19, 1981.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	10.7 (July)	13.0 (July)	10.9 (July)	13.1 (June)	5.8 (July)	19.6 (July)	6.6 (July)	5.1 (June)
Industrial production*	9.3 (July)	6.3 (June)	−8.0 (May)	−4.5 (June)	−1.9 (June)	−5.7 (June)	−2.6 (March)	1.9 (June)
Trade balance† *(billions of local currency units)*	−$3.12 (June)	C$0.57 (June)	£0.31 (Feb.)	−FF3.85 (July)	DM1.70 (June)	−Lit.790 (June)	−SF0.51 (July)	¥579 (June)
Money supply (M1)*	7.8 (July)	3.0 (June)	12.5 (June)	10.6 (April)	1.1 (May)	11.9 (April)	−2.3 (May)	−2.4 (April)
Velocity of money (M1)*	12.9 (Mar.)	−0.14 (Dec.)	9.8 (Dec.)	n. a.	0.7 (Mar.)	6.7 (Dec.)	n. a.	10.5 (Dec.)
Reserves minus gold *($ million, change from previous month)*	190 (June)	−110 (June)	−1,124 (June)	−4,045 (June)	−1,508 (June)	−1,603 (May)	−768 (May)	181 (June)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Dec 1980

Francophone Africa's Dilemma

Following the socialist victory in France, many investors began selling French stocks and moving their funds into assets denominated in other currencies, responding to fears of a franc depreciation. At the same time, however, capital began pouring into France from the nations of French-speaking Africa. This apparent anomaly is the result of the French-franc-pegging policy of the Francophone African nations, which have chosen to fix their currencies to a major world currency rather than allowing them to float freely. And in view of the shift in the nature and direction of the French government, it has prompted an exchange-policy reappraisal throughout French-speaking Africa.

The CFA (Communauté Financière Africaine) franc is the currency of French-speaking Africa, and two central banks—the Banque Centrale des États de l'Afrique de l'Ouest and the Banque des États de l'Afrique Central—regulate monetary and exchange-rate policy in their respective African regions. Since independence, the Francophone monetary authorities have pegged the CFA franc to the French franc at the ratio of FF1.00 to CFA 50.00.

The economic theory of fixed exchange rates teaches that a reserve-currency country sets the tone for monetary policy and the resulting level of interest and inflation rates in those countries whose currencies are pegged to it. In this sense, pegging countries usually benefit. Other consequences of pegging are even more clearly beneficial. Local capital markets can mature more quickly as they are linked in a stable fashion to well-developed financial markets in the reserve country. Further, investment funds from industrialized countries are more easily attracted, and trade flows are enhanced.

Now, however, Francophone Africa must decide whether it can accept France's new monetary policies and their inflation and interest-rate consequences. Prior to the socialist victory, interest rates in French-speaking Africa were roughly comparable with those in France. But interest rates in France soared after the election to satisfy investor demand for higher returns for holding francs despite expectations of rising inflation and currency depreciation. As interest rates surged in France, the central banks of French-speaking Africa resisted the rise in rates on CFA-denominated assets. This led investors in CFA francs to switch rapidly into French francs at the fixed exchange rate, to earn the higher interest rates paid in France, putting pressure on the CFA franc.

One of three alternative responses—all politically difficult—must be chosen by the Francophone African nations: 1) delinking the CFA franc from the french franc, 2) imposing restrictive currency, capital, and trade controls, or 3) allowing interest rates to rise to a level consistent with those in the reserve-currency country. If no action is taken, market arbitragers will force a rise in interest rates in the African economies.

Delinking the CFA franc from the French franc would be a costly response. It would deprive French-speaking Africa of its major source of economic stability: the free convertibility of its currency into French francs and the guarantee of the French treasury to act as lender of last resort. French commercial interests in France would also suffer from the loss of convertibility. French trade with Francophone Africa—a net surplus item—would shrink appreciably. Also, many French citizens working in Africa might feel compelled to return home. This could not only swell unemployment in France, but it would also reduce inward worker remittances.

The introduction of exchange controls applying to dealings within the African French franc zone would also be harmful. Such controls are currently minimal, with the exception of measures relating to gold, and the imposition of stronger controls would require the concurrence of all countries involved—unlikely as long as the monetary union exists.

Therefore, the inevitable Francophone African response—whether voluntary or not—is allowing higher interest rates. Unfortunately, it is an inopportune time for Francophone Africa to be raising interest rates, as the economies of the region are now relatively fragile. Yet, as long as market participants see no exchange risk between the CFA and the Franch franc, investors will arbitrage French interest rates against CFA interest rates, forcing a rise in CFA rates.

Events in Europe may ease temporarily some of the pressure on the CFA countries in the near term by reducing French interest rates. Should the French franc devalue within the European Monetary System—a strong possibility—French interest rates would likely decline vis-á-vis German rates. In the event of a franc devaluation against the DM, foreign-exchange-market investors would expect no new devaluation for at least six months or so. Hence, funds would flow from Germany to France to capture the higher interest rates in France, which would push French interest rates down over this period.

Over the longer run, however, the problem will persist as the French socialist policies ultimately lead to higher inflation in France, higher interest rates, and new fears of further devaluations. Nevertheless, the French-speaking African nations are expected to choose, then as now, to maintain the CFA franc-French franc currency link on the assumption that the benefits will continue to outweigh the costs of higher interest and inflation rates.

Wally V. Koch
Bluford H. Putnam

An Economic View of the Balance of Payments

Few economic concepts are as widely used—or as generally misunderstood and misapplied—as the balance of payments (BOP). Many of the term's misapplications arise from attempts to infer substantive meaning from accounting conventions that correspond imperfectly to the economic concepts policymakers have in mind. This problem cannot be completely resolved, since international transactions are recorded in the BOP under accounting definitions.

The U.S. BOP is a summary of all international transactions. Since it is based on double-entry bookkeeping, total debits always equal total credits; in a trivial sense, the overall BOP always balances. Of interest to economists and policymakers, however, is *how* it balances—that is, which sections, or accounts, of the BOP are in surplus and which are in deficit, and why. There is no single BOP definition, in either an accounting sense or an economic sense, that is appropriate for all situations. Thus, correct use of the BOP lies in applying the proper concept to the proper problem.

A useful approach to understanding the BOP lies in relating the various bookkeeping definitions to imbalances in the markets identified by economists in analyses of the "general equilibrium" of the domestic economy. An imbalance in a balance-of-payments account can then be thought of as corresponding roughly to excess demand or supply in one of these markets. Thus, the BOP concepts most often reported in the press—the balance on merchandise trade, the balance of goods and services, and the current account—are all ways of describing excess demand or supply in what economists call the "goods market" (which actually includes both goods and services). The balance on the capital account represents the excess demand or supply in the "bond market" (a term used by economists to encompass all financial assets not defined as money, such as stocks, bonds, and short-term financial paper). Finally, international-reserve movements, recorded in the U.S. BOP as the change in net holdings of U.S. Treasury instruments by foreign monetary authorities—reflect excess demand or supply in the domestic "money market" (see below).

BOP and Corresponding Markets

BOP Component	Domestic Market
Balance on Merchandise Trade Balance on Goods and Services Balance on the Current Account	Goods Market
Capital Account Balance	Bond Market
Change in International Reserves (Exchange Market Adjustment)	Money Market

The economically relevant definition of the BOP in a given situation depends upon imbalances in the domestic market to which it is directly related. For example, an excess supply of money will be reflected in an outflow of foreign reserves; since the United States has traditionally been a reserve-currency country, this flow is observed as an increase of foreign official holdings of U.S. debt. On the other hand, an excess domestic demand for goods may manifest itself as a negative U.S. balance of trade position.

The goods market seems to be the source of much of the confusion about the U.S. external position. A deficit in the merchandise trade account is often cited as a serious problem—even when the balance of goods and services is in surplus. In fact, even the goods and services account is an incomplete measure of activity in the "goods market." More useful is the entire current account, which comprises goods, services, and unilateral transfers.

The various accounting measures of imbalances in the goods market are often abused by diverse groups seeking policy actions favorable to their interests. For example, U.S. protectionists are fond of citing the huge U.S. merchandise trade *deficit* as justifying higher tariffs or quotas. Some foreigners, however, point to the U.S. current-account *surplus* to argue that the United States should reduce barriers protecting American industry, decrease subsidies to American exporters, or revalue the dollar. Obviously, this sort of "partial equilibrium" analysis leads to recommendations of partial solutions that can sometimes cause general problems for the economy.

Similar misunderstandings pervade discussions of bond-market imbalances. For example, net reinvested earnings of U.S. incorporated affiliates show up in the BOP as a debit to the capital account (and a credit to the current account). Partial analysis—pointing to this "capital outflow"—could be used to build support for capital controls, even though the "outflow" might exist only in an accounting sense. The capital account of the BOP can be a useful guide to the health of the domestic bond market, but it requires careful analysis.

Finally, changes in international reserves can easily be misinterpreted, since excess demand or supply in the domestic money market can also show up as changes in the external value of the dollar. The BOP reserves account can be said to reflect the "overall" U.S. payments position. But it is an imperfect measure. The health of the dollar can be better gauged by looking directly at domestic money-market imbalances.

In sum, the various BOP definitions are meaningful for policy only if the accounting definitions are interpreted properly in the correct economic sense. The BOP data should be used for policy formulation only with great care, and it should be kept in mind that policies based on partial analysis can do severe damage to the overall economy. *D. Sykes Wilford*

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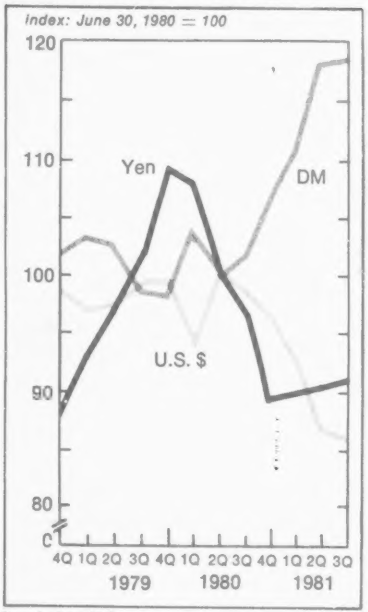
The SDR's Growing Role

Since the redefinition of the Special Drawing Right (SDR) by the International Monetary Fund last January, the simplified five-currency composition has proved much more popular with private markets than the old sixteen-currency version. Indeed, a number of banks and interbank brokers can now handle SDR-denominated transactions, deposits and loans. The chief factor impeding more rapid development of these markets has been the shift of monetary policy in the United States to a stance of stricter control and the consequent resurgence of the dollar's usefulness as an international reserve currency.

Relative value of SDR in terms of selected currencies*



* end of period

Nonetheless, even in a world in which the dollar remains the premier reserve vehicle, SDR-denominated instruments offer attractive characteristics not possessed by other reserve assets. Specifically, in today's environment of highly volatile exchange rates and interest rates, it is imperative that financial managers develop exposure-limiting strategies that take into account the interrelationships between exchange rates and interest rates. Furthermore, since future payments and earnings streams are often highly uncertain, diversified hedges may make more sense than multiple individual hedges. In these circumstances, the SDR can be a useful tool for managing residual exchange-rate and interest-rate risk in one simple strategy. Borrowing (lending) in terms of SDRs reduces the likelihood of a simultaneous increase (decrease) in both the exchange value of and interest rate on the borrowed (placed) unit of account. And having a diversified instrument that is directly tradable offers economies of scale and simplicity of management.

How rapidly the markets for SDR-denominated instruments will grow in the future will depend importantly on the actions of official institutions. Greater activity by official institutions in placing SDR-denominated deposits would be a major boost. So would further official borrowing. Although a few bond issues and syndicated bank borrowings have been arranged, the supply of official debt denominated in SDRs is still very small. A highly significant move in this direction would be the decision of the IMF to tap private credit markets directly and denominate those borrowings in SDRs. The advisability of such a step will apparently be a major item on the agenda of the forthcoming meeting of the IMF's Board of Governors later this month.

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Canadian oil accord may help sustain buoyant growth.

Canada's economic momentum is proceeding at a faster pace than previousl expected. Real GNP advanced at a 5.2% annual rate in the second quarter, le by large increases in residential construction and plant/equipment spending. Thi acceleration followed a 4% real GNP surge in the first three months of the yea and is being matched by declines in the rate of inflation and unemployment. Th GNP deflator fell to 6.4% in the second quarter, compared with 10.8% in the first And the unemployment rate dropped to 7% in August from 7.3% in January. A continuation of these trends could be encouraged by the September 1 oil agreemen between the Canadian federal government and the Albertan provincial government. Resolving a major internal policy dispute, the agreement provides fo higher oil prices and changes in the shares of oil and gas revenues going t Ottawa, Alberta, and the oil industry. The accord has already had positiv effects. It has boosted the Canadian dollar exchange rate and heightened expectations of stepped-up oil and gas investment.

Swiss government gives priority to fighting inflation and bolstering franc

Effective September 2, the Swiss National Bank boosted its discount rate t 6% from 5% and its Lombard rate to 7.5% from 6.5%, the fourth rise this year i these key lending rates. The latest move demonstrates a resolve to maintain restrictive monetary policy to underpin the Swiss franc exchange rate in the fac of rising inflation. In the last three months, the consumer price index has rise at an annual rate of 11.3% and is now 7.4% above its year-ago level. The hik in interest rates coincides with a deteriorating business outlook and indicate the priority accorded to the fight against inflation. Although the next mov in short-term interest rates is expected to be downward, the central bank wil seek to lag any decline in U.S. and German rates. The monetary authoritie recognize that because of the high-interest-rate policy, they will fall short o their 4% annual growth target for the adjusted monetary base.

Belgian authorities aim to stabilize internal and external deficits.

Belgium's internal and external disequilibria continue to worsen. A trade deficit of some $3.3 billion was posted for the first four months of the year, compare with a shortfall of $2.4 billion for the comparable 1980 period. In addition, th central government's budget deficit for 1981 to date is estimated at well above th revised 187-billion franc ($4.7-billion) target, and the public sector's borrowin requirement for all of 1981 is likely to exceed 400 billion francs, rising furthe in 1982 unless there is a change in policy. Responding to the widening budge and trade deficits, the government has agreed in principle to hold the 198 public deficit to 200 billion francs through a combination of BF 92 billion i expenditure cuts and BF 44 billion in higher taxes, mainly in the form of increases in several categories of the value-added tax. The measures, if adopted would hold Belgium's public-sector borrowing requirement to less than 12 of GNP, a figure that is still too high if the planned reduction in the trad deficit is to be accompanied by a revival in private investment.

Dutch authorities seek to cut public deficit.

More than three months after general elections in May, the Netherlands political parties have reached agreement on a new left-of-center coalition. Whil details of the new government's economic program have not yet been announced its overall aim is to reduce the public-sector deficit—expected to reach 8% of national income this year, up from 7.5% last year—and channel public spendin away from current expenditure toward investment. Significant reductions in th public-sector deficit, however, will prove difficult in the face of an unemploymen rate of nearly 9%, and as long as the foreign markets of the Netherlands' export-dependent economy remain depressed.

Guatemalan economy undermined by political turmoil.

Political turbulence is behind the rapidly deteriorating economic performanc in Guatemala. Badly shaken private-sector confidence, substantial capital flight inadequate care for crops, and stifled trade flows and tourism have dampene economic growth and put pressure on the balance of payments. Real economi growth was 3% last year, compared with an annual average of 6% from 1977 through 1979. And real GDP will probably be flat or show a decline this year. The 1980 current-account deficit was lower than that of 1979—$170 million versus $206 million—owing to the export strength of sugar, bananas, and nickel. But Guatemala had difficulty financing it, and international reserves dropped to $445 million by the end of last year from $700 million a year earlier. Continued low prices for the country's principal exports and problems in the agricultural sector suggest that the current-account shortfall will expand to some $300 million this year. The overall balance of payments will similarly worsen; international reserves in June were already down to $273 million.

Hong Kong's economic boom may have peaked.

The growing belief that Hong Kong's extended inflationary boom has peaked was further substantiated by a dip in the money supply in July. The decline, reflecting a reduction in bank loans and advances, was manifested in all the monetary measures: M1 fell 1.8%, M2 dropped 1.4%, and M3 narrowed by 3.3%. Other signs of a cooling off of the boom include a softening in the stock market and in real estate prices. The widely followed Hang Seng index, which peaked at 1810 on July 17, was down to 1598 by September 5, while in real estate there have been widespread reports of vacant properties kept off the market to prevent declines. The official consumer price index, however, has yet to decelerate from the 18%+ rate of advance posted for the first half of the year. A cooling down of the economy would be welcome on several counts. It would relieve the pressure on the trade balance, which has registered widening deficits, steady the Hong Kong dollar on the foreign-exchange markets, and ultimately reduce the rate of inflation.

Pakistani external accounts poised for deterioration.

Pakistan turned in a surprisingly good balance-of-payments performance in fiscal 1980-81 (ended June 30). The value of exports increased about 20%, with shipments of raw cotton and small-scale industrial products particularly strong. Imports, previously expected to surge because of the import liberalization measures adopted under the IMF's Extended Fund Facility program, rose only 15%. Despite an increase in the trade deficit to $2.8 billion, the current-account deficit, at $1.1 billion, remained virtually unchanged from its 1979-80 level, owing to a 20% jump in worker remittances. Over the next two years, Pakistan's trade and current-account gaps are likely to widen. With the rupee pegged to the U.S. dollar, Pakistan's exports have become less price competitive because of the dollar's appreciation. At the same time, additional modest measures have been announced to liberalize imports. As a result, the current-account gap is projected to widen to $1.4 billion in 1981-82 and to $1.7 billion in 1982-83. With the strong inflows of aid anticipated, however, such deficits should prove manageable.

International coal trade set for decade of strong growth.

Despite a slowdown in the rate of growth of coal exports this year, the long-term outlook for world coal trade remains bullish. The volume of coal traded internationally in 1981 is expected to show only a modest increase over 1980. A mild winter and advance stockpiling of coal by electric utilities, as well as continued sluggishness in the European steel industry, minimized the net effect of labor disruptions in the United States and Poland—historically the world's largest exporters of coal. An improvement in economic activity in the coming year and continued diversification to coal as a primary energy source by the oil-dependent, coal-resource-poor areas of the world should produce an acceleration in international coal trade in 1982—a trend that is expected to continue throughout the decade. The volume of coal exports is expected to more than double over the course of the 1980s, to a level of over 455 million metric tons per year by 1990, with the United States, Australia, South Africa, and Canada emerging as the major suppliers.

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Aiding the Thrifts

The latest in a series of measures designed to alleviate the problems of the nation's depository institutions will take effect next month. First, savings and loan associations and mutual savings banks will be able to swap their old low-yielding fixed-rate mortgages for more liquid Federal Home Loan Mortgage Corporation (FHLMC) participation certificates, which they may then sell or use as collateral for certain borrowings. Second, banks and thrifts may issue the new "all savers" certificates. The yield on these instruments is pegged at 70% of the current one-year Treasury bill rate, with the first $1,000 ($2,000 for married couples) of interest tax exempt. Unfortunately, neither of these steps offers either a "quick fix" or a cost-effective solution for the problems of troubled institutions.

The financial difficulties of thrift institutions (and some banks as well) stem from unbalanced asset and liability structures. Until recently, thrift structures reflected stringent regulatory constraints. Thrifts' traditional posture of relying heavily upon short-term funds—mostly deposits—to invest in long-term assets—mostly fixed-rate mortgages—left them extremely vulnerable to rises in short-term interest rates. Since deposit rates could not be adjusted promptly to market rates, because of regulation, depositors tended to withdraw their funds to place them in higher-yielding alternatives. The thrifts' chief alternatives to raising consumer deposit interest rates have been greater funding reliance on money-market liabilities with no rate ceilings or the sale of assets—if old mortgages, at a loss. Sizable "carry losses"—i.e., the margin by which funding costs exceed returns on assets—have reduced net worth positions to the point where a number of institutions, according to Federal Home Loan Bank Board (FHLBB) Chairman Richard Pratt, now show an excess of liabilities over assets.

Some industry representatives have characterized this situation as a crisis, which, if not corrected quickly, could lead to widespread failures. Only one institution has actually failed this year, however, and even that was attributed to unsound practices rather than general financing conditions. Indeed, for most institutions liquidity has not been a serious problem, and cash flows, despite negative current earnings, have remained positive. This is largely because most of their interest expense is not withdrawn, but rather becomes new deposits. The increased amount of deposit insurance—to $100,000 per account—enacted in 1980 has undoubtedly been an important factor.

Although liquidity should be sufficient to meet the operating needs of most thrifts for the foreseeable future, regulators realize that reforms are necessary to improve profitability. They have accordingly taken steps to allow these institutions to adapt better to the new economic environment. The deregulation legislation enacted last year provided for a phaseout of all deposit-rate ceilings, allowed thrifts to issue NOW accounts, and authorized increased latitude in consumer and other non-mortgage financing.

Similarly, in 1980, the FHLBB permitted thrifts to shorten the maturity of their assets by sanctioning the issuance of renegotiable and variable-rate mortgages. While these measures will enable thrifts to cope with interest-rate risk in the future, thrift earnings still reflect the impact of their sizable portfolios of old low-yielding fixed-rate mortgages. It is this problem that the most recent regulatory measures address.

The FHLMC plan to swap these old mortgages for participation certificates would not protect thrifts from sizable losses, however, since these mortgages would be sold at their current market value—at a deep discount from their par values. In addition, the maximum amount that the FHLMC is planning to swap ($2 billion this year and $20 billion in 1982) represents only a small percentage of the amount of remaining old mortgages (between $300 and $400 billion yield less than 10%). The all savers certificates, on the other hand, enable thrifts and banks to raise funds at costs well below those incurred on a taxable basis for a comparable maturity. For example, based on the latest Treasury auction, all savers certificates would yield about 12.6%, significantly less than the current 16% rate on six-month money-market certificates. However, at the current rate, and assuming a volume of $100 billion and a marginal tax rate of 40%, they could cost the Treasury (and ultimately the taxpayers) more than $5 billion. Thus, as a subsidy, this plan is little different in principle from other proposals that have been rejected. (The latter include a suggestion that the government buy old mortgages at par.) Furthermore, under a recent plan, the Federal Reserve and Federal Savings and Loan Insurance Corporation (FSLIC) have already agreed to make advances to ailing thrifts at below-market rates.

Some maintain that since many of the regulatory restrictions that caused financial difficulties in the past have now been lifted, thrifts should resolve their current problems themselves. To help in this regard, an accounting rule change would allow the spreading of current losses over several years, thereby encouraging thrifts to sell their old mortgages. In those cases where thrift difficulties have been especially severe and will probably last longer, thrift regulators have encouraged (even contributed financing to) amalgamations; this process will likely expand eventually to include authorization for commercial bank acquisitions of thrifts.

In the final analysis, liberalized accounting rules and expanded amalgamations would be more effective than FHLMC participation certificates and much less costly than all savers certificates. Their main deficiency, of course, is that they would take more time to have a positive impact on profitability. In light of the industry's generally favorable cash flow position, however, further emergency aid does not appear to be necessary.

Carl Alan Batlin

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
													12-month changes				exchange rate in U.S. dollars	change from year earlier		
			6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	September 9, 1981		current monetary conditions	
Africa	Algeria	Start-up of LNG exports to Panhandle Eastern in United States delayed until November.	May	+ 8%	29.0*	1,525	July	3,338	— 4%	4.2	0	Oil output 867,000 bpd in first half, down 12% from year earlier.	Dec. '79	+ 12%	Dec.	+ 17%	.2275	—13%	Claims on private sector rising steadily.	Algeria
	Egypt	Official value of pound devalued from 70 peasters per dollar to 84, effective August 1.	Sept.	+ 53%	16.4*	400	June	677	— 33%	2.9	116	Second stage of Suez Canal expansion to begin in January 1982.	Jan.	+ 17%	May	+ 8%	1.23	—13%	Interest on savings deposits to be raised.	Egypt
	Gabon	Non-oil sector expected to lead this year's projected 3% real GDP growth.	June	+ 2%	3.6	6,545	Apr.	211	+469%	3.2	13	Lower oil earnings point to deficit on current account next year.	June	+ 10%	Mar.	+ 12%	.00346	—28%	Credit expansion slows.	Gabon
	Kenya	Elimination of sales tax on imported capital goods proposed; import duty to remain.	Dec.	— 6%	6.8	425	June	332	— 42%	2.0	206	External debt service to absorb some 17% of foreign-exchange earnings.	May	+ 9%	Feb.	0	.1235	—12%	Interest rates to continue rising.	Kenya
	Liberia	IMF extends $60-million 12-year loan at 6% to help cover 1981-82 deficit.	Dec.	+ 1%	0.7	380	Feb.	15	— 70%	0.3	62	Despite liquidity squeeze, no exchange or profit-repatriation controls applied.	Dec.	+ 9%	Mar.	— 8%	Par	—	Liquidity very tight.	Liberia
	Libya	Development outlays slowed by drop in oil export revenues.	Apr.	— 1%	23.0	8,050	May	13,378	+ 41%	18.1	0	Oil output 1.5 million bpd in first half, down 21% from year earlier.	n. a.	—	Dec.'79	+ 33%	3.41	+ 1%	Credit generally available.	Libya
	Morocco	World Bank lends $140 million for industrial development.	Mar.	— 4%	15.3*	788	June	123	— 52%	0.4	44	Phosphate exports in first half up 41% from same 1980 period.	Mar.	+ 10%	Mar.	+ 6%	.1880	—29%	Money supply expanding more slowly.	Morocco
	Niger	Budgeted 1981 investment below development plan projections.	n. a.	—	2.4	453	Apr.	107	— 10%	4.3	[illegible]	Poor uranium price outlook implies reduced export earnings.	Mar.	+ 16%	Sept.	+ 22%	.00346	—28%	Bank borrowing rises sharply.	Niger
	Nigeria	New export guarantee scheme (capitalized at 4 mn. naira) to insure risks not previously covered.	Apr.	+ 11%	78.0	1,013	June	8,610	+ 4%	4.7	0	Foreign commercial borrowing up sharply as large current-account gap looms.	Sept.	+ 9%	Dec.	+ 48%	n. a.	—	Fall in foreign reserves tightens liquidity.	Nigeria
	South Africa	Projected $3.0-billion budget deficit next year forecloses possibility of tax reductions.	May	— 10%	76.9	2,650	June	737	— 13%	0.4	[illegible]	Value of gold output in first half 21% below year ago.	June	+ 15%	Apr.	+ 51%	1.0475	—21%	Interest rates not expected to fall before mid-1982.	South Africa
	Togo	Development program may need scaling down because of export revenue shortfall.	n. a.	—	1.2	470	Apr.	102	+ 35%	n. a.	2	Phosphate sales weak; cocoa and coffee earnings hurt by low prices.	Sept.	+ 16%	Sept.	— 10%	.00346	n. a.	Debt service burdensome despite rescheduling.	Togo
	Tunisia	Saudi businessmen to invest $340.5 million in two tourist complexes.	Mar.	+ 37%	7.1*	1,135	June	485	— 24%	1.6	[illegible]	Phosphate rock prices holding steady.	May	+ 7%	May	+ 23%	1.98	—21%	Foreign assets rising steadily.	Tunisia
	Zambia	Producer prices boosted 26% to spur agricultural output and revitalize economy.	June	— 8%	3.5	600	May	89	— 8%	0.8	474	U.K.'s ECGD export cover remains suspended as payment backlog persists.	June	+ 13%	Mar.	+ 14%	1.21	— 6%	Agricultural Development Bank prepares to begin operating.	Zambia
	Zimbabwe	Increase of 37% in budgeted public spending planned for FY 1981-82; deficit of $120-million projected.	Dec.	+ 14%	4.4	595	Dec.	264	— 6%	2.4	0	Lower gold sales, higher imports shift 1Q trade balance to deficit of $42 mn.	Dec.	+ 8%	Dec.	+ 34%	1.51	n. a.	Money supply growth rapid.	Zimbabwe
Middle East	Kuwait	Budget outlays for 1981-82 put at $10.6 billion, up from $10.3-billion allocation in 1980-81.	Apr.	0	27.3	19,870	July	3,704†	+ 17%	7.5	[illegible]	Oil output 1.1 million bpd in first half, down 30% from year earlier.	Dec.	+ 8%	May	+ 24%	3.5250	— 5%	Dinar bond market reopened with KD 7-mn. issue Aug. 7.	Kuwait
	Qatar	Cement output to be expanded fourfold; polyethylene plant to be built at Umm Said.	Apr.	+ 22%	3.2*	15,214	Dec.	343†	+ 19%	2.7	[illegible]	Price of NGL exports to Japan cut from $37.57 per barrel to $34.49.	n. a.	—	Dec.	— 9%	.2775	+ 1%	Credit to private sector continues to increase.	Qatar
	Saudi Arabia	Implementation of several petrochemical projects proceeding on schedule.	Apr.	+ 39%	117.6	19,500	July	27,897†	+ 42%	11.8	[illegible]	Oil price held at $32 per barrel; output to be cut by one million bpd.	Dec.	+ 2%	Jan.	+ 9%	.2935	— 2%	Jan. foreign assets were $92.3 bn., up 46% from Jan. '80.	Saudi Arabia
	United Arab Emirates	Federal government allocates $3.7 billion for development projects in 1981-85 five year plan.	Apr.	+ 15%	16.0*	19,275	July	2,670†	+ 34%	3.0	0	LPG exports to Japan from Abu Dhabi Ruwais gas project begun in Aug.	n. a.	—	Apr.	+ 15%	.2735	+ 2%	Industrial Bank to be capitalized at at least $545 million.	United Arab Emirates

*1979

†Excluding state reserves

World Interest Rates

market rates as of Sept. 9, 1981; bond yields as of Sept. 4, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	20.69	12.00	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	6.25
Day-to-Day Money	16.50 Sept. 10	20.50	12.50	10.90	17.375	12.00	20.125	13.125	7.50	7.4375
Treasury Bills 91-day, Middle Rates	15.30 discount basis	20.25	13.00	15.75	17.83 one-year	n. a.	18.80 79-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	17.25 finance paper discount basis	21.50 finance paper 15% tax w/h	12.281	12.90 Certified	17.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.90	21.30 15% tax w/h	13.1875	12.90 Certified	not traded	9.90	22.30	no market	11.125	no market
Government Bonds Long-term, new and old issues, average yield	15.09	17.50	14.87	10.7787 20% tax w/h	16.87	11.04	21.04	12.57	6.56	8.66
Industrial Bonds prime, long-term, new and old issues, average yield	15.97 Aa Industrials	18.25	16.08	17.02	17.79	11.75	21.26	13.93	6.6312	7.26
Bank Short-Term Rate to Best Borrowers (prime rate)	20.00	22.75	13.50	18.00	18.50	14.50	22.50 ⅛ quar'ly fee on outstdng.	15.50	9.50	6.75
Bank Time Deposits 3-month	17.375 Cert. of Dep.	21.60	13.625	15.50	17.375	12.50	10.75	14.00 large deposits	9.25 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	18.375	no market	13.875	no market	24.50	12.375	no market	14.0625	11.00	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8288	1.7875	.02299	.1725	.4127	.000825	.3729	.4781	.00428
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	2.9175 *D*	4.2741 *P*	2.470 *D*	5.522 *D*	5.7779 *P*	9.2333 *D*	4.5488 *P*	7.1719 *P*	10.4519 *P*

Eurodollar Deposits
(London, interbank, bid)
September 9

7-day	17.25
1-month	16.875
3-month	18.25
6-month	18.50

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.7951
U.S.-Canada Treasury Bills	−0.795
U.S.-Canada Finance Co. Paper	−1.0375
Eurodollars-U.K. Local Auth. Deposits	+0.351

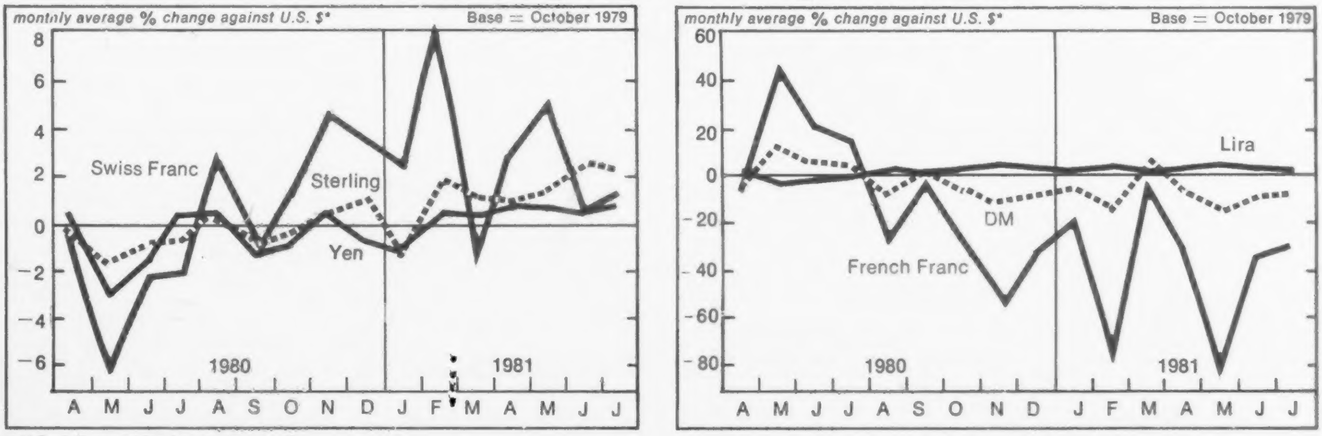
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	17.00
Over 7 yrs.	16.875
DM Bonds	
7 yrs. and under	11.75
Over 7 yrs.	11.25

Gold Price
London afternoon fixing
436.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Movements of major currencies against the dollar



* U.S. dollars per foreign currency unit

Exports Underpin Finland's Economy

Finland's economy has sustained one of the highest growth rates in Europe since 1979, and although momentum is being lost this year, 1981 growth will continue well above the European average. Finnish economic growth, adjusted for inflation, was 7.2% in 1979 and 4.9% in 1980—strong enough to spur an expansion in the volume of fixed investment of nearly 12% last year. Although only little growth is expected through yearend, owing to a slowdown in both the domestic and external sectors, a steep recession is not expected. Indeed, 1981 is likely to post a relatively strong real GDP advance of 2%, thanks largely to the continued strength of exports.

Largely responsible for Finland's export-fueled economic vigor is its unique trade relationship with the Soviet Union (and the Council for Mutual Economic Assistance nations). The USSR, the source of Finland's rising oil imports, has stepped up its demand for Finnish export products sufficiently to offset Finland's higher oil bills. Thus, while the surge in oil prices since 1979 has had the same inflationary impact on Finland as it has had on other OECD countries—keeping the annual rate of inflation in double digits since 1980—it has not had the usual recessionary impact.

External sector cushioned

Finland's protracted trend of rapid export growth (inflation-adjusted export growth over the last five years has averaged 10%) weakened with the start of 1981. While the volume of goods exported increased by 9% in 1980, export growth in the first quarter of 1981 was only 2%, with the total increase for the year projected to remain at about that rate.

Exports have held firm longer than expected in the face of a slight deterioration in price competitiveness and sluggish demand of Western markets. Although exports to market-economy countries slackened during the last half of 1980, exports to CMEA countries rose considerably. The fast growth in such exports, as mentioned earlier, was Finland's response to an enlarged deficit in bilateral trade with the Soviet Union triggered by higher Soviet oil prices. In addition, the start of a new five-year trade agreement with the USSR has helped accelerate exports to the Soviets. Next year, Finnish exports to the West are expected to revive somewhat, so that growth in overall export volume is likely to accelerate further.

Import growth has also eased sharply. Import volume advanced 16% in 1979 and 12% in 1980, but the rapid climb halted in the last quarter of 1980, and import volume declined in the first quarter. The recent sharp import slowdown was partly the result of much-reduced energy imports owing to problems in obtaining Polish coal. But weakening domestic demand and output and tight financial markets have been the major causes. Apart from cyclical influences, Finland's intensive energy-saving efforts of recent years and moves to replace imported energy with domestic fuel have led to a permanent decline in energy imports. Last year, despite GDP growth of some 5%, the total volume of energy utilized rose only 1% and energy imports actually decreased slightly.

With exports projected to rise slightly in 1981 (to $14.5 billion from $14.1 billion last year) and imports likely to drop marginally (to $15.5 billion from $15.7 billion in 1980), Finland's $1.6-billion trade deficit last year appears set to narrow to about $1 billion this year. Similarly, the current-account deficit is forecast to decline to $1 billion from $1.34 billion last year—with the invisibles account, traditionally in small surplus, likely to balance.

Sustained domestic sluggishness seen

Finnish private consumption in 1980 increased in line with the growth in households' real disposable incomes—about 2.5% in volume terms. Consumer spending growth both this year and next, however, is expected to slow somewhat because of declines in real disposable income.

The strong growth trend in fixed investment experienced since 1979 is clearly reversing. Last year's 13% investment expansion is expected to be followed by growth of 4%-5% this year, with a small contraction (some 2%) forecast for 1982. Behind this rather steep slowdown are the general weakening of the economy and demand expectations, and the completion of many large investment projects started during the investment boom period. Also, a deterioration in profits and in rates of manufacturing capacity utilization in many sectors implies less willingness by firms to invest. Although the government has taken some measures to stimulate investment—including easing monetary policy, using investment reserves built up during the boom, and shortening the investment tax levy period—the expected downswing in investment is unlikely to be avoided.

Nor will the public sector provide much stimulus. Public spending in 1980 increased by about 3.5%, while public investment climbed 4%, contributing to a public-sector deficit of $1.1 billion (2.2% of GDP). Efforts to limit state borrowing—which totaled $1.3 billion in 1980—and to control the tax burden will limit the growth of public expenditure in the current and in coming years. Much of the decline in public spending will come from public investment, which is expected to remain stagnant in the near future, while public consumption will probably continue to post increases.

Exports Underpin Finland's Economy *(continued from page 7)*

The weakness of demand in both the export and domestic sectors has since the last half of 1980 shown up in declining manufacturing orders, increasing stocks of finished goods, underutilization of production capacity, and reduced profitability. But a sharp recession is precluded. Indeed, the volume of industrial output is expected to continue rising, although at the lower rate of 3%-4% this year and next, compared with expansion rates of 10.5% and 7.1% in 1979 and 1980.

The export sectors will carry the brunt of the recession, particularly the forest industry—where output is forecast to drop 3%-4% this year—and the pulp and paper industry. The anticipated slackening of domestic investment has negative implications for the metal, building-material, and construction industries. Favorable export prospects for the metals and engineering industries, however, will more than offset the falloff in domestic demand in these sectors. Overall, real GDP is projected to increase by 2% both this year and in 1982.

The rapid economic growth of the last few years has expanded employment opportunities, particularly in manufacturing and services, and helped drive down the unemployment rate to 4.8% last year from 7.5% in 1978, despite substantial growth in the labor supply. But this reduced unemployment level is still uncomfortably high, compared with the figures in previous boom periods, owing to structural problems in the labor market. And with the economic outlook promising anemic demand for labor, the rate of unemployment is expected to increase this year to an average of 5%, with the 1982 average forecast at 5.5%. The government has indicated that it will give high priority to reducing unemployment permanently, but labor policy measures to achieve this goal have yet to be announced.

Inflation easing somewhat

Finland's rate of inflation responded sharply to the surge in oil prices in 1979, accelerating to 11.6% in 1980 from 7.5% in 1979. An end to the fast pace of rising prices for imports, domestic products, and building costs, however, came in the closing months of last year. And the rate of consumer price inflation has eased in the current year. Still, prices in April were on average 12.5% above their year-earlier level, and the average rise in the consumer price index for 1981 is forecast at 11%. The reasons for the gradual easing of inflationary pressure are the declines in imported inflation, settlement on a reasonably moderate two-year incomes policy, the favorable pricing policies of the industrial firms—and a slowdown in the growth of the money supply. Expansion of the M2 money stock is estimated at 12% in 1981, down from nearly 15% in 1980 and from more than 17% in 1979.

Policy flexibility afforded

The relative balance in Finland's external accounts provides the Finnish authorities with a good opportunity to even out the recession. Policymakers can focus on stimulating production and employment without the usual concern about aggravating the current-account deficit. Relative to a nominal GDP likely to grow from $50 billion last year to $59 billion in 1982, current-account deficits in the $1-billion range would not constitute a limiting factor for economic policy.

The contents of the 1982 government budget—to be presented to Parliament later this autumn—will set the tone for Finnish economic policy in the near future. Indications are that next year's overall policy stance will be stimulative, funded by $520 million in financial reserves accumulated during the last boom period. The utilization of public investment reserves is scheduled to begin next month. Export and cyclical reserves are expected to be released at the beginning of next year.

Apart from the injection of these reserves, however, fiscal policy's stimulative impact is expected to be small. The authorities are reluctant to use government spending as a cyclical policy tool and are aiming to reduce state borrowing and the continually high level of public expenditure.

Nonetheless, with the weakening of economic output and the abatement of inflationary pressures, the Bank of Finland's monetary policy has moved cautiously in the direction of less restrictiveness. Interest rates on call money and on deposits of cash reserves by commercial banks were reduced this past spring. Moreover, the authorities are willing to allow greater participation by foreign banks in the domestic money market. The easing of monetary policy, however, will not enhance the availability of credit in the short term, as commercial banks are trying to reduce their heavy loans from the Bank of Finland. Consequently, interest rates are expected to remain high.

In sum, the Finnish economy's period of rapid growth has clearly ended, in line with the economic downturns experienced elsewhere in Europe. But Finland's unique trade relationship with the Soviet Union and the policy flexibility its reasonably sound external accounts afford it give the country the opportunity to sustain comparatively high economic growth. In addition, the Finnish authorities' conservative economic management and wage policy imply favorable prospects for reducing inflation and maintaining international competitiveness.

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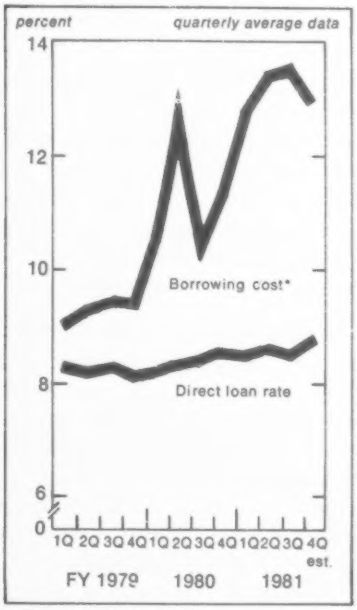
Eximbank in A Double Bind

The U.S. Export-Import Bank is caught between two mandates: remaining "self-sustaining" by keeping its borrowing and lending costs in line, and providing subsidized export financing support that is "competitive" with that offered by European and Japanese governments. It has not been able to do both. The bank's policy of offering highly subsidized–and competitive–interest rates on its long-term export financings over the past few years, despite steadily rising market interest rates, has come home to roost. The Eximbank now projects a potential operating loss of $10 million in fiscal 1981 and as much as $100 million in 1982.

Faced with declining net income, the Eximbank's new chairman announced revised loan guidelines in mid-July to shore up the bank's finances. Most important, interest rates on long-term direct loans were raised to 10.75% from 8.75% and a two-percentage-point fee on Eximbank credit values was imposed. But a 1978 international agreement on government-backed export loans specifies minimum allowable interest rates far below these levels (7.75% on loans to buyers in developing countries). And most European and Japanese exporters are currently offering terms at these minimums, thanks to continued large subsidies from their official export credit agencies. Consequently, U.S. exporters risk the potential loss of millions in big-ticket export contracts to their European and Japanese counterparts.

Thus, a lot is riding on the October 5 round of OECD-sponsored negotiations to lift the agreement's minimum interest rates nearer to market levels. The failure of the 22 countries participating in the export credits arrangement to consent last spring to linking minimum rates to some measure of market rates has produced a concentrated effort to boost interest-rate minimums by at least two to three percentage points–and quickly. One breakthrough has been an international accord establishing an interest-rate minimum of 12% for exports of competing aircraft--an export item excluded from the current export credits pact. Nonetheless, if the United States and its negotiating partners fail to agree to a sizable generalized increase in minimum allowable export credit rates next month in Paris (and to set up a mechanism for periodic rate adjustments), many large U.S. exporters will be confronted with highly uncompetitive export financing terms for the foreseeable future. At the same time, however, foreign governments sticking to their current financing policies will continue shouldering the burden of ballooning export-finance subsidies.

Eximbank lending rates versus borrowing costs



* Federal Financing Bank

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Danish policy austerity suggests another GNP decline this year.

The Danish government is apparently sticking to its restrictive policy stance, making likely another decline in real GNP this year after a 1% drop in 1980. Owing to recession in Germany and Sweden, even the export sector is unlikely to show any growth, despite the substantial fall in the kroner's effective exchange rate that has resulted from a stronger U.S. dollar and U.K. pound. The restrictive policy has aggravated unemployment, which is projected to average 8.5% of the labor force in 1981, but it is lowering the annualized inflation rate—which has fallen to 11.6%. The trade balance has also improved, but high interest charges on large overseas debt promise substantial current-account deficits for the foreseeable future. On the domestic front, public finance remains a serious concern. The government budget for 1982 projects a rise in the total borrowing requirement to kr. 80 billion ($10.7 billion), which is unnerving the bond markets. The effective yield on 20-year state bonds recently hit 21.8%, and although yields have fallen slightly since then, long-term rates remain exceptionally high.

Swedish devaluation accompanied by measures to limit inflationary impact.

Despite the moderation embodied in a two-year wage agreement announced in February 1981—which allows for a 7% wage rise this year and 6% next year—production costs have continued to rise faster in Sweden than in many other countries. The exporting industries have begun to suffer, and their problems have been compounded by the kronor's strength vis-á-vis most West European currencies. Responding to the latter problem, the government devalued the kronor by 10% on September 14. To ensure that the kronor's decline does not get reflected in higher costs, the authorities have announced a price freeze for the remainder of 1981 together with a reduction in value-added taxes. In addition, the government has proposed that corporations set up special investment accounts with the central bank so that increases in profits are channelled toward new fixed investment rather than toward financing inflationary wage demands. Finally, the central bank has indicated that the devaluation will not alter its current tight monetary stance. In sum, the stage would seem to be set for improvement in the Swedish economy and containment of inflation. Inflationary pressures may intensify, however, if unemployment begins to fall in the early part of next year.

Imports and debt costs widen Turkey's external deficit.

Despite rapid export growth, the Turkish authorities anticipate a current-account deficit of over $3 billion this year, up from $2.7 billion in 1980. Exports in dollar terms rose 50% in the first half of 1981 to $1.95 billion, and worker remittances for January-May were up 26% from their year-earlier level. At the same time, however, imports in dollar terms advanced 48% to $4.43 billion, widening the trade deficit to $2.48 billion—a level that exceeds the government's $4.2-billion projection for 1981 as a whole. Furthermore, high U.S. interest rates are raising debt interest payments, countering the beneficial effect of increased worker remittances. Still, these developments must be viewed in the context of an economy that has resumed growth after almost three years of stagnation.

Argentine exchange-rate policy reaping benefits.

Argentina's current economic recession is characterized by rising unemployment and climbing inflation. Real GDP declined 1.6% in the first half of 1981, and unemployment in Buenos Aires is approaching 5%. Meanwhile, the annualized rate of consumer price rise jumped to 114% in August from 82% earlier this year. These various results stem from both the previous policy of peso overvaluation and the turbulence in the foreign-exchange market earlier this year. A series of devaluations has helped industrial exports but has also pushed up import prices. With relative calm prevailing in the markets in the past few weeks, the sharp peso devaluations have begun to yield trade dividends. A $345-million trade surplus was posted in the second quarter, in contrast to the previous quarter's $520-million deficit. The return to a more competitive trade environment should lift industrial output, although it will come too late to prevent an overall GDP decline for the year. It will, however, improve the current account and should help foster a rebound in economic activity next year.

Mexico on positive economic course, says President Portillo.

In his annual state of the nation message earlier this month, Mexican President Lopez Portillo applauded Mexico's recent 8% real GDP growth; the hike in proven oil and gas reserves to 72 billion barrels; and the creation of 3.4 million new jobs over the past five years. On the negative side, however, Portillo expressed concern about rising inflation; the larger trade deficit despite strong oil revenues; and the pressure on money creation stemming from the fiscal deficit. On balance, the presidential assessment suggests that Mexico is on the right economic course, and will likely continue on this path for the balance of the current presidential term, with no fundamental policy shifts foreseen.

Japanese domestic debt financing efforts meet with difficulty.

The Japanese government is having problems raising funds to finance its deficits through the issue of long-term national bonds. To keep debt financing costs low, the government pressures syndicates of financial institutions into underwriting new issues at below-market yields. As government debt has soared and as high U.S. interest rates have pulled up secondary-market yields, however, the underwriting syndicates have become increasingly reluctant to accept new issues at the existing terms. Only 1.08 trillion yen ($4.9 billion) of the planned 10-year bond issue of ¥6.8 trillion were sold in the first three months of the fiscal year. The underwriting syndicates refused to accept new issues in both July and August, which forced the government to sell the issues to its Trust Fund Bureau and through special private placement. Given these difficulties, the Ministry of Finance has agreed to a yield increase for the September issue. Such an increase may necessitate a rise in the bank debenture and long-term prime lending rates, but is not expected to affect short-term rates. The difficulty in selling national bonds is expected to put further pressure on the government to restrict expenditures to reduce its bond issue for deficit financing.

Malaysian policy of local ownership progressing slowly.

Malaysia's new economic policy goal of placing ownership of 30% of the country's industrial and commercial assets in ethnic Malay hands by 1990 moved a step closer to realization on September 7. On that day the National Equity Corporation, a Malaysian government body, purchased nearly eight million shares (valued at about $132 million) of the Guthrie Corporation, a London-based diversified company, 60% of whose assets consist of Malaysian plantations. Together with shares acquired earlier, the latest equity investment gives Malaysia a majority interest in Guthrie. The government already owns a 25% interest in Sime-Darby, the other giant plantation and trading company with interests in Malaysia. It is therefore possible that a consolidation of Malaysia's interests in the two companies is being contemplated. The New Economic Policy is now more than halfway through its 1970-1990 span, with progress toward the 30% target lagging—only 12% of industry and commerce's assets were in Malay hands last year. Moreover, a large part of this share was held by the National Equity Corporation and other government entities, for eventual distribution to individual Malays.

A squeeze on Nigerian oil receipts likely to produce a policy reassessment.

The sustained weakening of world oil demand has trimmed back projections of Nigeria's 1981 export receipts, over 90% of which derive from oil sales. Despite the 10% discount (announced August 26) on the $40 per barrel official price, there are still no signs of a significant upturn in output, which in August barely exceeded one-third the January level of 2.1 million barrels per day. With exports currently running only slightly above 500,000 barrels per day, and with pressure from refiners for further price reductions, even a moderate upturn in output toward yearend is unlikely to produce oil export receipts exceeding $14 billion—which would be 40% below last year's figure. The impact of the shortfall on the budget—which depends on oil revenue for about 80% of its funds—and on the balance of payments will be cushioned somewhat by the healthy level of international reserves and Nigeria's underborrowed position on world financial markets. Nevertheless, a projected current-account deficit of $8-9 billion and a $6-7-billion budget deficit will present policymakers with very difficult choices.

Mortgage Market Weakness Pronounced

Although expenditures on new housing have fallen off quite sharply recently, the decline in the growth of household mortgages has been even more precipitous. In the first half of this year, household mortgages outstanding increased at a seasonally adjusted annual rate of $77 billion, equivalent to only 75% of household residential investment (or investment in new homes). This contrasts markedly with the experience of the late 1970s, when household mortgages outstanding rose by 110% of household residential investment.

During most of the late 1970s, when the real cost of mortgage financing was relatively low, households were inclined to borrow heavily in the mortgage markets. Moreover, the regulatory climate and market conditions were such that lenders were more willing to supply mortgage credit. Such an environment made it easier for consumers to tap the accumulated equity in their homes as a source of purchasing power.

Conditions have obviously changed since then. Financing costs have jumped sharply relative to income. Over the last 12 months, mortgage financing costs have risen by over 25%, while personal income has increased only 12%. Consequently, fewer individuals qualify for mortgages. And for those who do qualify, the high real cost of mortgage credit has decreased the attractiveness of such credit as a source of purchasing power. Moreover, the current profit squeeze on thrift institutions has made them more cautious in supplying funds, as has the slow deposit inflows they have experienced. In addition, tight credit market conditions have depressed sales of existing homes, and have therefore limited the tendency for households to "trade up" to larger homes requiring larger mortgages.

The use of "creative financing" techniques—whereby the seller provides some of the financing to the buyer—is also contributing to the slowdown in mortgage credit growth relative to residential investment. While this development has actually offset to some extent the effect of tight mortgage market conditions on the housing market, it has limited the ability of sellers to utilize house sale proceeds for such other uses as consumption.

Given the further hikes in mortgage costs in recent months, as well as the trend toward tightening nonmortgage rate terms by a number of lenders, it is likely that mortgage credit will continue to grow slowly, at least through yearend. Such mortgage market conditions may restrain consumption in the fourth quarter, thereby dampening the stimulatory effects of the October 1 tax cut. However, the slow growth in this sector of the credit markets may allow "room" for the prospective large Treasury borrowings in coming months without causing any further rise in interest rates.

Surge Seen in M2 Growth

It seems virtually certain that the broader measure of the money supply, M2, will accelerate sharply in October. And in view of the Federal Reserve Open Market Committee's recent strategy of placing greater weight on the behavior of M2 in determining monetary policy, the question arises of how the Federal Reserve will interpret or react to the surge.

One reason to expect M2 to accelerate in October is that the all savers certificates—included in M2—come on line then. Their yields are equivalent to 70% of the investment yield on one-year Treasury bills. From October 1 to October 5 (the date of the next one-year bill auction) the rate institutions may pay on these certificates is 12.61%. This yield is higher than yields on tax-exempt municipal notes of similar maturities. Moreover, since the one-year Treasury bill rate has fallen by over 100 basis points since the last auction, the rate on the certificates based on the next auction will probably be much lower. Consequently, a large move into these certificates in early October is probable.

Much of the funds channeled to all savers certificates will surely come from money market certificates and money market funds. This would not affect M2, which consists of currency, demand and other checkable deposits, small time and savings deposits, overnight repurchase agreements and Eurodollar deposits, and money market mutual fund shares. However, quite a few billion dollars are likely to move into these certificates from sources not included in M2, including tax-exempt bond funds and direct holdings of market securities.

Another source of the anticipated bulge in M2 will be shifts into money market funds by such institutional investors as trust departments—a process already begun. The recent sizable drop in money market rates has not yet been matched by the yields on money market funds. This is because money fund yields are based on yields on instruments purchased over the last month or two, and thus still reflect earlier higher interest rates.

Given these influences, M2 growth in October is very likely to exceed the latest publicized Federal Reserve target, even if the economy and the demand for money and credit are weak. But the money markets are highly uncertain about the Federal Reserve's reaction to this bulge. If monetary policy is based on keeping M2 growth within the latest announced targets, the bulge would suggest some tightening. However, it is doubtful whether the Federal Reserve will react in such a knee-jerk fashion. Unfortunately, the Federal Reserve has not given any indication as to just how it might adjust the M2 targets—or if it will at all. One possibility, and one certainly in keeping with past policy, would be to create a new aggregate called "M2-adjusted" that would purge any estimated effect of the introduction of the all savers certificate on M2 growth.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				central bank rate	exchange rate in U.S. dollars		
		latest data	12-month change	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	September 23, 1981		current monetary conditions	
Austria	Domestic demand stays weak, but export strength boosts aggregate demand.	Mar.	+ 1%	75.8	+ 3.6%	July	4,497	+ 8%	2.5	0	Trade deficit set to narrow.	June	+ 6%	May	+ 9%	6.75%	.0618	Interest rates await fall in German rates.	**Austria**
Belgium	Domestic and export demand continue weak; fiscal deficit remains high.	May	— 2%	118.9	+ 1.5%	July	5,753	— 33%	1.0	0	Reduced export competitiveness keeps trade deficit widening.	July	+ 8%	Mar.	+ 3%	13.00%	.02442	Interest rates rise owing to increased pressure on franc	**Belgium**
Britain	Economic decline seems to have ended, but sustained recovery still looks some way off.	July	— 6%	518.7	— 1.4%	July	15,780	— 29%	1.7	423	Trade data still unpublished but signs are of continuing surplus.	Aug.	+ 12%	June	+13%	14.00%	1.8040	Money growth continues to exceed official target.	**Britain**
Denmark	Economic output remains depressed.	May	+ 13%	67.1	— 0.8%	July	2,851	— 5%	1.9	0	Current-account gap narrowed in IIQ; first-half deficit was kr. 6.36 billion.	May	+ 12%	Dec.	+10%	11.00%	.1400	Concerns over budget deficit keep rates high.	**Denmark**
Finland	Exports continue to bolster economy; 2% real GDP growth projected for 1981.	May	+ 7%	51.0	+ 6.0%	July	1,542	— 24%	1.4	75	Jan.-July trade surplus of fmk. 584 million vs. fmk. 3-billion deficit year ago.	July	+ 13%	Feb.	+ 2%	9.25%	.2260	Monetary conditions remain restrictive.	**Finland**
France	Further measures taken to stimulate demand; 3.5% real GDP target set for 1982.	June	— 5%	651.1	+ 1.2%	July	24,845	— 9%	2.4	0	Current-account gap set to widen as economy revives.	July	+ 13%	Apr.	+10%	9.50%	.1830	Little scope for drop in rates with franc under pressure.	**France**
Germany	Exports and export orders surge; restrictive 1982 budget proposed.	July	— 3%	827.7	+ 1.8%	July	47,384	— 7%	3.4	0	Trade balance improves in June-July; '82 current-account surplus possible.	Aug.	+ 6%	May	+ 2%	7.50%	.4337	Rates weaken somewhat in response to stronger mark.	**Germany**
Greece	Government resigns in advance of October general elections.	Dec.	+ 3%	38.2	+ 1.6%	June	682	— 18%	0.6	40	Current-account deficit widening.	June	+ 23%	Dec.	+15%	20.50%	.0210	Credit remains tight.	**Greece**
Ireland	Industrial output rose slightly in June, but recent tough budget precludes significant recovery.	Apr.	0	17.1	+ 2.1%	July	2,209	— 11%	2.5	0	Trade deficit expanding sharply: £243 million in July vs. £84 million in May.	May	+ 17%	July	+16%	15.00%	1.6050	Rates surge since July owing to money growth curbs.	**Ireland**
Italy	Industrial production falls sharply, with no upturn expected before next year.	July	— 2%	394.9	+ 4.0%	July	17,941	— 21%	2.3	0	Import deposit requirement to be renewed.	Aug.	+ 19%	Apr.	+12%	19.00%	.00086	No rate easing likely before EMS readjustment.	**Italy**
Netherlands	New coalition formed in wake of May elections; tight preliminary 1982 budget proposed.	May	— 6%	159.9	+ 1.0%	July	9,043	— 19%	1.5	0	Current account expected to move into surplus this year.	July	+ 7%	May	+ 3%	9.00%	.3922	Guilder stays strong in EMS; rates move with Germany.	**Netherlands**
Norway	Recent election showed swing to right, but business conditions unlikely to change for a while.	June	— 3%	55.4	+ 3.6%	July	5,481	+ 16%	4.3	0	Small deficit in Aug.; year-to-date trade balance shows kr. 9.23 bn. surplus.	July	+ 14%	Apr.	+15%	9.00%	.1670	Monetary conditions remain tight.	**Norway**
Portugal	Tighter fiscal stance and world recession offer little prospect of strong growth.	Sept. '80	0	24.1	+ 3.9%	June	576	+ 29%	0.8	62	Export growth constrained by weak external demand.	June	+ 18%	Mar.	+22%	18.00%	.0158	Bank credit growth under stricter official control.	**Portugal**
Spain	Both domestic and external sectors remains weak.	Dec.	+ 5%	208.5	+ 0.5%	June	10,427	— 12%	3.7	204	Tourist season proved better than expected.	June	+ 14%	May	+12%	8.00%	.01062	Monetary growth slowing.	**Spain**
Sweden	Economy remains depressed, with unemployment rising.	May	+ 20%	124.3	+ 2.3%	July	3,633	+ 3%	1.5	0	Devaluation will enhance trade balance's longer-term prospects.	July	+ 13%	n. a.	—	12.00%	.1796	Central bank sees little scope for money policy easing.	**Sweden**
Switzerland	Most indicators point to further decline in business activity.	Mar.	— 3%	99.8	+ 2.4%	July	10,227	— 19%	4.0	0	Current-account upturn owes to narrowing trade gap and invisibles inflow.	Aug.	+ 7%	May	0	6.00%	.5076	Rates rise with money policy tightening.	**Switzerland**
Canada	Strong second-quarter GNP advance fueled by consumer income gains and investment spending.	June	+ 6%	246.5	+ 0.1%	Aug.	3,290	— 18%	0.5	0	Canadian dollar depreciation helps export growth.	Aug.	+ 13%	Aug.	+ 4%	19.67%	.8347	Central bank and prime rates decline slightly.	**Canada**
United States	Economic activity slumping in response to continued monetary restraint.	Aug.	+ 8%	2,626.1	— 0.2%	July	17,713	+ 66%	0.8	0	Current-account surplus of $1.07 billion posted in IIQ, buoyed by services.	Aug.	+ 11%	Aug.	+ 6%	14.00%	—	Dollar weakens as money market rates fall.	**United States**

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World Interest Rates

market rates of Sept. 23, 1981; bond yields as of Sept. 18, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 17.00	19.67	14.00	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	7.25
Day-to-Day Money	15.00 Sept. 24	20.00	14.00	12.30	18.50	12.00	20.125	10.75	24.00	7.4375
Treasury Bills 91-day, Middle Rates	14.17 discount basis	19.40	14.5625	15.75	n. a.	n. a.	18.749 65-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	15.00 finance paper discount basis	19.50 finance paper 15% tax w/h	13.6256	12.90 Certified	19.00 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	15.15	19.60 15% tax w/h	14.625	12.90 Certified	not traded	9.90	22.40	no market	10.875	no market
Government Bonds Long-term, new and old issues, average yield	14.54	17.30	15.40	10.3637 20% tax w/h	16.66	10.66	21.16	12.13	6.11	8.47
Industrial Bonds prime, long-term, new and old issues, average yield	15.55 Aa Industrials	18.125	16.72	17.015	17.78	10.95	21.37	13.52	7.00	7.29
Bank Short-Term Rate to Best Borrowers (prime rate)	19.50	21.25	15.00	18.00	18.50	14.50	22.50 ⅛ quar'ly fee on outstdng.	14.50	9.50	6.75
Bank Time Deposits 3-month	15.625 Cert. of Dep.	19.60	15.25	15.40	19.00	12.30	10.75	12.375 large deposits	9.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	16.625	no market	15.375	no market	26.50	11.875	no market	12.375	10.9375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8347	1.8040	.02442	.1826	.4337	.00086	.3922	.5076	.00439
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.771 *D*	1.5965 *P*	2.06 *D*	9.8631 *D*	4.9436 *P*	16.51 *D*	4.188 *P*	5.685 *P*	9.473 *P*

Eurodollar Deposits

(London, interbank, bid)
September 24

7-day	13.4375
1-month	16.125
3-month	17.4375
6-month	17.50

International Arbitrage

(3-month, hedged) — *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.7893
U.S.-Canada Treasury Bills	−1.3104
U.S.-Canada Finance Co. Paper	−1.4616
Eurodollars-U.K. Local Auth. Deposits	n. a.

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	17.00
Over 7 yrs.	17.00
DM Bonds	
7 yrs. and under	10.50
Over 7 yrs.	10.5625

Gold Price

London
afternoon fixing

456.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	10.9 (Aug.)	12.7 (Aug.)	11.5 (Aug.)	13.4 (July)	6.0 (Aug.)	19.2 (Aug.)	7.4 (Aug.)	4.4 (July)
Industrial production*	7.5 (Aug.)	6.3 (June)	−5.8 (July)	−4.5 (June)	−2.7 (July)	−2.0 (July)	−2.6 (March)	1.9 (June)
Trade balance† *(billions of local currency units)*	−$1.46 (July)	C$0.44 (July)	£0.31 (Feb.)	−FF3.85 (July)	DM3.66 (July)	−Lit.800 (July)	−SF0.99 (Aug.)	¥547 (July)
Money supply (M1)*	6.2 (Aug.)	4.0 (Aug.)	12.5 (June)	9.5 (April)	2.0 (May)	11.8 (April)	0 (May)	−2.4 (April)
Velocity of money (M1)*	12.9 (March)	−0.14 (Dec.)	9.8 (Dec.)	n. a.	0.7 (March)	4.6 (March)	n. a.	13.0 (March)
Reserves minus gold *($ million, change from previous month)*	−720 (July)	−729 (July)	−1,292 (July)	−603 (July)	−1,264 (July)	562 (July)	−1,915 (July)	−316 (July)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Trading Companies: A Bit of Japan in the U.S.

The continuing strength of the Japanese economy coincident with economic malaise in the United States has made U.S. admiration of Japan a widespread and growing national pastime. Americans are duly impressed that Japan—resource-poor and utterly dependent on imports of raw materials—has managed to achieve and sustain high productivity and economic growth with relatively low inflation, while the resource-rich U.S. economy remains stagnant. They wonder whether there are any lessons the United States can learn from Japan.

Many American businessmen and "Japanologists" maintain that social and cultural influences are largely responsible for the Japanese economy's remarkable vigor. They attribute Japan's economic growth to such sociocultural characteristics of its people as group-orientation, patience, discipline, and a deep respect for education (shared by a homogeneous population), which are deeply rooted in Japan's Confucian and Buddhist ethics. Others attribute Japan's economic success to a survival mentality that stems from a shortage of arable land and natural resources and severe overcrowding. Still another view holds that Japan's destruction during World War II gave it the "opportunity" to rebuild—with U.S. aid—a modern industrial complex from the ground up, a course not available to the victorious allied nations.

Since all of these social and cultural influences cannot be duplicated in the United States, the adaptability of the Japanese economic model on a "super-macro" level is not the issue. The relevant question is whether any particular Japanese economic institutions or policies can be adapted. Since the Japanese trade performance is a hallmark of Japan's economic success, there is especially pronounced U.S. interest in the concept of the trading company, a powerful and uniquely Japanese institution, and its application in the United States.

The roots of Japan's trading companies

The importance of trading companies in Japanese trade and economic growth is undisputed. The share of the 10 largest general trading companies in Japanese exports and imports of more than $250 billion last year was over 50%. If the shares of some 8,000 smaller trading companies are included, trading firms would account for about 75% of all Japanese trade.

The emergence of the Japanese trading company, which traces back to the Meiji era before the turn of the 20th century, was a uniquely Japanese event. Japan's complete ignorance of foreign markets nurtured by a long history of isolation made the acquisition of such knowledge a prerequisite for opening up the country to foreign trade. The trading companies were viewed as a means of consolidating resources and spreading risks in the pursuit of uncertain foreign ventures.

Looking at the general theory of international trade, the economic role that Japanese trading companies play becomes clearer. Traditionally, trade is viewed as a response to existing price (or cost) differentials—the neoclassical trade model—and as the consequence of the maturation of products in domestic markets—the product life cycle theory. New products are introduced in an industrialized country owing to the large size of the home market and the advanced state of technology. Only with these products' gradual maturity in the domestic market and in the presence of international cost differentials is exporting considered. The costs of adjustment to foreign demand patterns and of marketing are naturally high, however. They include transport costs, tariff and nontariff barriers, as well as costs of repackaging and redesign. Substantial one-time investments are also required initially to learn about foreign markets and business practices and to develop contacts. If these costs are excessively high, potential exports are discouraged.

It is just such costs that trading companies reduce through specialization. And once the necessary fixed investment is made in the formation of a trading company, the marginal cost of service to a prospective exporter—as reflected in the fee charged—can be very small. The costs of product adaptation to foreign markets are reduced since the data obtained on foreign markets are incorporated in exporters' initial production plans. The trading companies can also increase the likelihood of any existing cost differentials being exploited, and shorten as well as smooth the transition from domestic to foreign marketing.

Trading company activities

The activities of Japan's trading companies go far beyond simply bringing together domestic firms and foreign customers. Their services include all trade-related activities ranging from handling export and import documents to sourcing finance, warehousing and insuring, and marketing and distribution in foreign countries. The gains from consolidation and specialization are obviously numerous. The trading companies, for example, permit economies of scale in accumulating foreign-business expertise and in gathering information that uncovers otherwise unseen business opportunities, including offshore deals between third-country customers.

Japan's trading companies also perform important financial functions. They are able to provide trade credits

Trading Companies: A Bit of Japan in the U.S.

(continued from page 7)

or obtain trade financing at favorable rates because of their size and industrial organization: a trading company in Japan is part of a large conglomerate that usually includes banks as well as industrial corporations. Japanese trading companies also assume business risks for their own account. Foreign-exchange risk, for example, is reduced and self-insured by pooling the foreign-exchange risks of various business transactions with long and short exposures to a variety of currencies. This advantage is of particular importance in trade with developing countries where hedging mechanisms (such as forward markets) are non-existent.

Adaptation in the United States

Although trading companies are the creation of the Japanese, the concept is applicable in other countries since the fundamental justification for them is economic. The need for storehouses of foreign-business expertise and economies of scale in trade servicing certainly exists in the United States as well as in many other countries.

Indeed, trading companies have already been adapted in South Korea and Switzerland; they are also being contemplated in Mexico and Canada. In the United States, the growing concern about international competitiveness of American firms—as well as the fact that the great bulk of U.S. exports are accounted for by only a small percentage of the largest U.S. firms—has generated significant interest in export trading companies. With the relative decline in the United States' traditional technological edge, U.S. firms have to compete increasingly on equal terms in foreign markets. The former American luxury of being able to deal passively with an established list of customers is gone, and active, aggressive marketing by U.S. domestic and multinational firms is now needed to retain or expand international market share.

Although there exists in the United States an abundance of economic information about foreign countries, knowledge and skills specific to foreign marketing are in short supply. U.S. businessmen need to examine foreign markets and be able and willing to adapt their products and services to different cultures and markets. They also need to overcome their traditional prejudice in favor of competition and resistence to bigness (and the resulting economies of scale) to compete internationally, as measures that promote domestic competition among firms can sometimes undermine their international competitiveness.

The growing U.S. concern about international competitiveness has spurred several bills seeking the creation of export trading companies in the United States. The bills now pending in Congress (the Senate has already passed one, while the House is considering no less than five versions) all seek to provide incentives to manufacturing firms—particularly small and medium-sized firms—to form export trading companies to market their products more effectively. The bills call for the relaxation and clarification of anti-trust provisions of U.S. law that would permit trading companies to consolidate export activities. They also authorize equity participation in trading companies by commercial banks. The various bills do differ in how and to what extent certification for anti-trust immunity is carried out and by which government agency, and in whether tax deferral privileges similar to those granted Domestic International Sales Corporations should also be granted to export trading companies.

The real controversy over the trading company legislation centers on both the certification and bank ownership issues. With respect to certification, it would seem that overly stringent requirements would create artificial barriers to market entry. One of the key reasons for these companies' success in Japan is competition within the industry. Relatively free market entry and the existence of numerous small competitors reduce the potential for oligopoly. Thus, certification requirements should be sufficiently non-restrictive to permit broad participation by the manufacturing community. In addition, U.S. trading companies should provide comprehensive services, including import and other trade-related services, in addition to export services.

The various bills pending would also allow commercial banks, their holding companies, and international banking subsidiaries to invest up to 5% of their capital in trading companies with the proviso that all investments over $10 million would require prior regulatory approval. This provision is facing stiff opposition in the House Banking Committee—where concern for the traditional distinction between banking and industry is strong—as well as by the Federal Reserve. Bank participation, is, however, a necessary ingredient for the success of trading companies. Such participation would mean instant availability not only of the necessary capital but also of the trade finance and international market expertise that would help infant trading firms compete with established Japanese trading concerns.

The exact form that U.S. trading company legislation will take is thus quite uncertain at this time. Yet in view of the Reagan administration's concern with U.S. economic revitalization and international competitiveness, and with U.S. government agencies such as the Export-Import Bank decreasingly able to play a large role in facilitating exports, the chances for the ultimate emergence of trading companies in the United States are favorable.

Jongmoo Jay Choi

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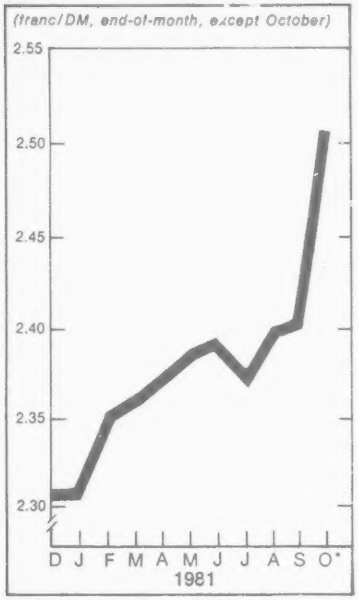
France's Commitment to Reflation Reaffirmed

The October 4 realignment of the central rate structure of the European Monetary System (EMS) should restore—for a time—the freedom of the French authorities to pursue a more consistent set of macroeconomic policies. In recent months, the Mitterrand government had been in a severe policy bind. The reflationary fiscal measures taken by the government encouraged adverse expectations about inflation and the balance of payments. This necessitated restrictive monetary actions by the Bank of France, in order to fulfill its commitment to defend the franc. A further widening of this rift between fiscal and monetary policy would have jeopardized the government's recovery program. The French authorities undoubtedly would have preferred to delay a franc devaluation within the EMS until the dollar began to exhibit significant weakness against the EMS currencies. But the unveiling on September 30 of the highly stimulative 1982 government budget posed the strong likelihood of accelerated reserve losses if the old parity had been defended further.

The French franc/
DM exchange rate



* Oct. 5

Although the 8.5% devaluation of the franc against the mark in terms of EMS central rates was somewhat larger than anticipated, it is highly questionable whether the new parity will endure as long as the old (24 months). While Germany is strongly committed to relatively restrictive fiscal and monetary policies, the Mitterrand government appears just as intent on pursuing an expansionary course. The newly announced budget projects a 27% increase in government spending for fiscal 1982, implying a 35% increase in the budget deficit even if the rather optimistic 3% real economic growth target is met.

The government hopes to limit the inflationary consequences of these policies and of the devaluation by a series of direct controls—temporary price freezes on all service industries and on certain key consumer goods—and negotiations with labor and business over wage-price restraint. Although these tactics may well succeed in preventing a further acceleration of inflation in the short run, they will also tend to delay further the recovery of economic activity in the private sector. The hard reality is that current official targets with respect to growth and inflation are inconsistent, given the shift in inflationary expectations brought about by the initial policy actions of the Mitterrand government. If the government's overriding objective continues to be controlling unemployment, it seems unlikely that the newly announced franc/mark parity will survive the coming year.

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Sterling taking a pounding.

After nearly four years of continued strength, the British pound has turned shakey. Its trade-weighted index began to fall from the end of May, and each successive month has witnessed a further slide. September saw particularly strong selling pressures. The month closed with the exchange-rate index down some 10.4% from September 1980 and with the country's foreign-exchange reserves down $815 million. Concerned about the inflationary impact of the rising import bill that follows sterling weakness, the government has given a big push to market interest rates. Bank base (prime) rates jumped from 12% to 14% in mid-September and again to 16% on October 2. These increases lifted sterling slightly from its September lows, but the currency remains relatively weak. The market's reappraisal of the pound stems partly from the current weakness of the oil market and partly from a growing feeling that the depth of the U.K. recession—unemployment is 11.1% and rising, while industrial output is below its level in 1975—will force a more reflationary policy before long. However, the oil market often changes rapidly, and the economic news is not all bad. Inflation is much slower now than last year, with August wholesale prices up 10.1% from August 1980, and signs point to possible wage settlements in the just-begun annual wage round of approximately 8%. All in all, the outlook for sterling remains uncertain, which suggests that the British currency will exhibit volatility for the rest of the year.

Spanish concern over growing public deficit mounts.

Spanish attention is increasingly focused on the issue of public finances. Even prior to the onset of the current recession, the government's financial position was deteriorating steadily, with revenue growth failing to match the escalation in expenditures. The recent poor economic performance has underscored this trend. Rapidly rising unemployment (now 13.5%) has led to large increases in benefits payments, and the sluggish economy has limited revenue growth. As a result, the state deficit at the end of May stood at 348.3 billion pesetas (about $4 billion), more than double the end-May 1980 shortfall and well above the official target of pta. 435 billion for all of 1981. The 1982 draft budget forecasts a further widening of the deficit to almost 700 billion pesetas (3.5% of GDP) next year, with a 75% rise in the allocation for unemployment benefits. Meanwhile, the Spanish employers' federation has withdrawn from the previously negotiated tripartite wage and employment pact for 1982, in protest against the new budget that provides for a small increase in company taxes.

Finnish budget deficit looks set to widen.

The Finnish government is putting the final touches on its 1982 budget. With economic growth in 1982 expected to slow from 1981 and unemployment set to climb, the budget deficit would appear poised to widen substantially, given the prospect of reduced revenues and greater expenditures for social welfare. A debate has thus begun on ways to cut planned expenditures and boost revenue. It is expected that most of the public spending cuts will be investment-related. Whatever the outcome, it appears certain that the budget deficit will widen during 1982. Observers predict that the government will have to borrow about 6 billion markkaa next year ($1.3 billion, at the current exchange rate), compared with a borrowing requirement of 3.5 billion markkaa in 1981.

Brazilian trade balance moving toward annual surplus.

If present trends continue, Brazil could record a balance-of-trade surplus in 1981, its first since 1973. Since May, Brazil has posted monthly surpluses on its trade account, which have reduced the cumulative trade deficit for the first eight months of 1981 to just $36 million, as against almost $2.5 billion for the comparable 1980 period. Over this same eight-month period, export receipts rose by more than 18% while imports fell 0.7%. Export growth this year is being led by manufactured products and by non-coffee commodities. Indeed, Brazil is having considerable success with such new exports as frozen chicken, orange juice, and beef. Coffee export earnings, however, were down 35% from last year because of the softness of prices. On the import side, the only major item that showed an increase was petroleum—which owes solely to price rises as volume was down more than 9%. Imports of chemicals and capital equipment were also down considerably in the January-August period, reflecting the tight reins on aggregate demand and the consequent industrial slowdown.

India anticipating reduction in its huge oil bill.

India's oil import bill skyrocketed in the fiscal year ended March 31, expanding by 76% to total $7 billion. This sum equalled 45% of imports, nearly 78% of export receipts, and 4% of GDP in fiscal 1980-81. India's high dependence on oil imports, combined with a 46% jump in the average price of crude oil and petroleum products and the embargo on shipments of crude oil and oil products from the eastern state of Assam, were the chief reasons. The Assam embargo alone necessitated the import of an extra 3.5 million tons of oil products last year at an additional cost of more than $1 billion. This year, with oil shipments from Assam resumed, increased output from the Bombay High field, and moderation in oil price rises, India's oil import bill is expected to decline to $6.7 billion. In an effort to reduce further its dependence on imported oil, the Indian government is accelerating oil exploration and development and has invited foreign firms to participate. The level of oil imports in the second half of the decade will ultimately depend on the success of these efforts. However, just with the projected increase in output from existing fields, oil imports in volume terms are likely to be held below the record level of 1980-81 through at least 1984-85.

Singapore proceeding with restructuring its monetary bureaucracy.

The Monetary Authority of Singapore (MAS), which functions as Singapore's central bank, is still engaged in a major restructuring and restaffing. A major objective of the reorganization is improved management of Singapore's huge reserves of foreign exchange, securities, and other assets, which are estimated at as high as $20 billion. A new entity, the Government of Singapore Investment Corporation (GSIC), has been created, and it will be independent of the MAS within a few months. A substantial portion of MAS assets will be turned over to GSIC for management, although the MAS will continue to manage a substantial amount of assets as reserves to support the value of the Singapore dollar. With the new reserve-management system in place, the MAS will turn its attention to enhancing Singapore's sophistication as a financial center. MAS officials are intent on catching up with Hong Kong in the loan-syndication business and aim to make Singapore a more important center for money markets and foreign-exchange trading.

Saudi external surplus ballooned in 1980; more modest growth seen for 1981.

Saudi Arabia's current-account surplus widened sharply to an officially reported $35.2 billion in 1980 from $10.4 billion in 1979. Although import costs climbed by 32% last year to over $71 billion, gross export revenues soared by nearly 69% to $95.4 billion. The oil windfall was partly the result of a 4% rise in oil production to an average of 9.9 million barrels per day. But the primary reason was a sharply higher oil export price. Saudi light crude last year was priced at an average $28.67 per barrel, compared with $17.26 per barrel in 1979. In addition, income from official holdings of assets invested overseas (about $100 billion as of the end of 1980) reached nearly $7.5 billion last year, up sharply from $4.9 billion in 1979. The current-account surplus in 1981 is expected to expand once again, but more modestly. The $32 per-barrel price of Saudi light—instituted in November 1980—will most likely continue in force through yearend. And oil output is expected to average 9.8 million barrels daily. Consequently, gross oil revenues in 1981 are projected at $110 billion, while services exports are projected at $16 billion. Taking into account the U.S. dollar's strength this year, which has improved Saudi Arabia's terms of trade, expenditures on imports and transfers could increase by 21% to $86 billion. Based on these assumptions, a 1981 current-account surplus of some $40 billion is seen.

Prospects for Wage Moderation

After a three-month interlude, during which seasonal adjustment problems held the reported rate of unemployment down, the rate rose to 7.5% in September, returning to the plateau it has been on since the spring of 1980. While this high level of unemployment is undesirable in the long run, there are signs that it is having a moderating effect on wage demands. Such moderation would be of great importance to the Federal Reserve in its anti-inflation fight. But the wage restraint has not yet proven to be widespread.

The Fed attempts to peg growth in nominal incomes by fixing and adhering to specific money growth targets. How much of this rise in nominal income translates into real income gains is determined by the pricing behavior of firms and the wage demands of individuals. If wage demands do not moderate in the face of increasingly restrictive monetary targets, higher unemployment results, and real income falls.

The persistent high level of unemployment has, however, begun to lower nominal wage demands. The latest data show that the year-over-year increase in the hourly earnings index fell to 8.8% in July from its peak rate of 10% in January. In addition, moderating inflation, as measured by the Consumer Price Index, has also slowed wage increases by yielding workers smaller cost-of-living adjustments. Nonetheless, the wage moderation seen to date is not dispersed throughout the U.S. labor market.

Thus far, the manufacturing sector—where employment fell 400,000 in September while total U.S. employment was up—has shown the greatest decline in wage gains, among both union and non-union workers. Conversely, in the retailing and service sectors, where employment growth has been well above average, wage gains have either accelerated or remained steady.

The combination of continuing high unemployment and slower inflation is likely to restrain several major 1982 collective bargaining settlements and affect wage demands among non-unionized workers as well. Negotiations for 1¼ million union workers in trucking, autos, rubber, farm machinery, and textiles and clothing will likely be influenced by higher-than-average rates of unemployment and by declining union membership.

But critical to the Fed's monetary strategy is whether wage demands ease in currently less-distressed sectors such as electrical machinery and meat packing, and in non-manufacturing sectors such as retail trade. If they do, the groundwork will be laid for a less inflationary business expansion. If not, and if the Fed sticks to its very restrictive policy stance, the slump in the U.S. economy may widen to these sectors.

Whither Monetary Policy?

A great deal of uncertainty currently exists regarding whether the Federal Reserve will ease monetary policy in the near term. Furthermore, there is confusion over the extent to which—or even if—the Federal Reserve has "eased" in recent months. This confusion in part stems from different uses of the term "monetary ease."

According to one view, an easing in monetary policy occurs when actions by the Fed stimulate the growth of the money stock. Advocates of this view argue that the behavior of the money stock is a major determinant of total spending, and thus serves as an indicator of the thrust of monetary policy. There is no consensus among these advocates, however, on whether recent monetary policy has been "easy" or "tight."

For those who believe the narrowly-defined money supply is the relevant monetary indicator, policy has clearly been tight, since the growth of this measure has been weak over the past few months. Those who think that broader measures of money or credit are the appropriate indicators, however, come to a different conclusion, since these measures have continued to grow fairly rapidly.

Finally, those who look at measures such as bank reserves or the monetary base as indicators of monetary policy may not agree over the recent thrust of policy. According to Federal Reserve Board figures, total bank reserves adjusted for changes in reserve requirements grew at a seasonally adjusted annual rate of about 12% from June to September. According to figures compiled by the Federal Reserve Bank of St. Louis, however, adjusted bank reserves grew at an annual rate of only 2% over this period.

According to a different view, and one generally held in the financial markets, an "easing" in monetary policy means some action by the Fed that leads to, or is expected to lead to, a decline in the Federal funds rate. The markets, then, consider the behavior of the monetary aggregates as leading indicators of Fed actions. According to this view the Fed has clearly eased, in that its apparent reserves targets (along with its discount rate policy) have been consistent with much of the recent decline in the funds rate.

Thus, market participants, economists, and monetary policymakers often mean quite different things when they say "policy has eased." In this regard, it is important to recognize that Fed officials are usually not referring to interest rates when they say that monetary policy will remain "tight." In other words, "tight" policy can be associated with rising, falling, or stable interest rates.

Unfortunately, the Fed's precise definition of "tight" remains elusive. This, combined with the recently divergent behavior of various monetary aggregates, makes it extremely difficult to gauge the interest rate implications of statements by Fed officials that policy will remain "tight."

Asia and Oceania

Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes				exchange rate in U.S. dollars	change from year earlier	current monetary conditions	
												latest data	consumer prices	latest data	money supply(M1)	October 7, 1981			
Bangladesh	Interim government selling shares in public corporations and encouraging joint public/private ventures.	May	+10%	12.5*	$ 138	Aug.	136	− 15%	0.7	320	Trade deficit widening with deteriorating terms of trade.	July	+14%	May	+15%	.0650	− 4%	IMF drawing suggests domestic credit under control.	**Bangladesh**
Burma	Selection of new president this autumn may bring changes in economic policy.	June	− 3%	5.6*	174	Aug.	249	− 10%	7.4	44	Relatively heavy external borrowing begun in 1979 expected to continue.	June	− 4%	Oct.'79	+11%	.1400	− 9%	Pegged to SDR, kyat has depreciated against U.S. dollar.	**Burma**
China, People's Republic	Strong growth of light industry offsets decline in heavy industrial production.	June	+15%	242.2	246	June	3,822	+ 10%	2.4	510	Partial Japanese financing arranged for certain Japanese projects in China.	Dec.	+ 8%	June	+26%	.5700	−16%	Treasury bonds sold to reduce money supply growth.	**China, People's Republic**
Hong Kong	Stock market declines sharply from July peak; property market softens.	May	+29%	21.5	4,290	n.a.	—	—	—	—	Trade deficit widens as exports to EC weaken.	May	+14%	May	+19%	.1655	−17%	New credit curbs debated as HK dollar depreciates.	**Hong Kong**
India	Dry spell dims agricultural prospects, and resulting power cuts may constrain industry.	May	−20%	172.6*	257	May	6,242	− 13%	6.2	301	Reserves plummeting at almost double previous year's rate.	June	+14%	Apr.	− 7%	.1110	−11%	Banks to channel more credit to priority sectors.	**India**
Indonesia	Contracts for expansion of oil industry placed, despite softening demand.	Dec.	+25%	63.2	416	Aug.	5,917	+ 1%	5.6	0	Non-oil exports decline sharply, owing to lower commodity prices.	Aug.	+11%	May	+32%	.00161	—	Foreign assets of banking system still rising.	**Indonesia**
Japan	Package of measures to spur domestic economy likely to prove relatively ineffective.	July	+21%	1,044.0	8,940	Aug.	27,292	+ 22%	2.2	0	Imports of oil and manufactures to rise to avert trade friction.	Aug.	+ 4%	July	+ 7%	.004371	− [illegible]%	Japanese interest rates to follow U.S. rates down.	**Japan**
Korea	Industrial production recovering from slump, but machinery, chemicals, and auto sector lag.	July	+27%	57.8	1,513	July	2,337	− 26%	1.0	1,074	Exports of electronics, textiles, steel, and ships lead recovery.	July	+26%	July	+12%	.001470	−11%	Exchange rate virtually steady since May.	**Korea**
Malaysia	Government acquisition of Guthrie Corp. signals acceleration in New Economic Policy.	Apr.	− 6%	22.8	1,697	June	3,951	− 7%	4.1	0	Low prices for major export commodities widening trade deficit.	June	+11%	Mar.	+14%	.4320	− 8%	Government refuses approval for some capital outflows.	**Malaysia**
Nepal	Agricultural growth of 20%, non-agricultural growth of 8.6% reported for fiscal 1980-81.	June	+58%	2.0**	142	June	186	+ 1%	5.7	22	Import duties on luxuries raised to reduce trade deficit.	June	+14%	June	+14%	.0800	− 5%	Exchange rate unified at 13.2 rupees per dollar.	**Nepal**
Pakistan	Government pursuing less lenient labor policies.	May	+32%	27.8*	336	Aug.	790	+ 64%	1.9	598	Modest additional measures taken to liberalize imports.	June	+15%	June	+19%	.1020	+ 1%	Credit conditions continue restrictive under IMF guidance.	**Pakistan**
Philippines	Central bank and government move to support financially weakened firms as recession continues.	May	+12%	35.1	726	Aug.	2,282	− 4%	3.3	845	Trade deficit widens because of low commodity export prices.	July	+13%	June	+18%	.1300	− 2%	Banking system stabilizing with strong central bank control.	**Philippines**
Singapore	Investment and economic growth trends little affected by stock market and property declines.	June	+11%	10.5	4,390	May	6,670	+ 9%	2.9	0	Oil-related industries expected to slow down as oil glut continues.	July	+ 9%	May	+20%	.4793	+ 1%	Investment flows strengthen Singapore dollar.	**Singapore**
Sri Lanka	Budget for 1982 expected to increase taxes to mobilize domestic resources.	May	− 3%	4.1	277	Aug.	236	− 28%	1.6	328	Jan.-May trade deficit only slightly above year earlier.	May	+18%	June	+ 9%	.0525	− 9%	Bank rate raised further to 14%.	**Sri Lanka**
Taiwan	New plan targets 8% economic growth rate; public works expenditure to rise.	Apr.	−12%	40.2	2,278	May	3,008	+111%	1.7	0	Lower oil prices help offset decline in exports to some markets.	May	+19%	May	+14%	.0280	+ 2%	Small August devaluation to have minimal impact.	**Taiwan**
Thailand	Government restrains increase in minimum wage to 13%, despite labor protests.	June	+ 7%	32.2	693	Aug.	1,391	− 31%	1.6	485	Opening of gas pipeline expected to cut oil imports 20%.	July	+12%	Feb.	+ 7%	.0450	− 6%	July 15 devaluation should aid exports.	**Thailand**
Australia	Centralized wage-fixing system abandoned; labor market resorts to supervised collective bargaining.	June	+ 2%	137.9	9,435	Aug.	2,153	+ 46%	1.0	0	Government promotes greater local participation in resource projects.	June	+ 9%	June	+12%	1.1535	− 2%	Capital inflows slow, responding to government policies.	**Australia**
New Zealand	Synthetic fuels project valued at $1 billion given green light.	June	+ 9%	21.2*	6,714	Aug.	369	− 11%	0.8	73	Surplus U.S. butter bought to prevent world glut and fall in export price.	June	+15%	June	+ 6%	.8315	−15%	Federal budget deficit to expand in fiscal 1981-82.	**New Zealand**

*Fiscal year **1979

World Interest Rates

market rates as Oct. 7, 1981; bond yields as of Oct. 2, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 17.00	19.60	16.00	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	7.25
Day-to-Day Money	14.00 Oct. 8	20.00	15.50	14.75	18.50	12.00	20.125	12.625	7.50	7.4375
Treasury Bills 91-day, Middle Rates	13.88 discount basis	18.80	15.4375	15.75	18.30 1 year	n. a.	18.001 84-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	14.50 finance paper discount basis	18.95 finance paper 15% tax w/h	14.16	12.90 Certified	17.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.55	18.85 15% tax w/h	15.4375	12.90 Certified	not traded	9.90	22.10	no market	10.375	no market
Government Bonds Long-term, new and old issues, average yield	15.16	17.25	15.81	10.1375 20% tax w/h	16.84	10.49	20.74	12.36	6.12	8.471
Industrial Bonds prime, long-term, new and old issues, average yield	15.90 Aa Industrials	17.75	17.16	17.07	17.93	10.95	21.02	13.61	6.9625	7.27
Bank Short-Term Rate to Best Borrowers (prime rate)	18.50 Oct. 8	18.875	17.00	18.00	19.50	14.50	22.50 ¼ quar'ly fee on outstdng.	14.50	10.50	6.75
Bank Time Deposits 3-month	15.125 Cert. of Dep.	18.75	16.125	15.00	17.625	12.10	10.75	12.50 large deposits	10.25 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	16.25	no market	16.50	no market	21.625	11.50	no market	12.4375	10.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8332	1.8780	.0268	.1795	.4500	.000846	.4073	.5320	.00437
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	3.00 *D*	.15 *D*	6.50 *D*	5.40 *D*	4.70 *P*	8.00 *D*	4.00 *P*	5.65 *P*	8.80 *P*

Eurodollar Deposits

(London, interbank, bid)
October 8

7-day	**14.00**
1-month	**15.3125**
3-month	**16.25**
6-month	**16.50**

International Arbitrage

(3-month, hedged) **+** *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	**−1.196**
U.S.-Canada Treasury Bills	**−0.84**
U.S.-Canada Finance Co. Paper	**−1.19**
Eurodollars-U.K. Local Auth. Deposits	**+0.213**

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	**16.75**
Over 7 yrs.	**17.00**
DM Bonds	
7 yrs. and under	**10.75**
Over 7 yrs.	**10.50**

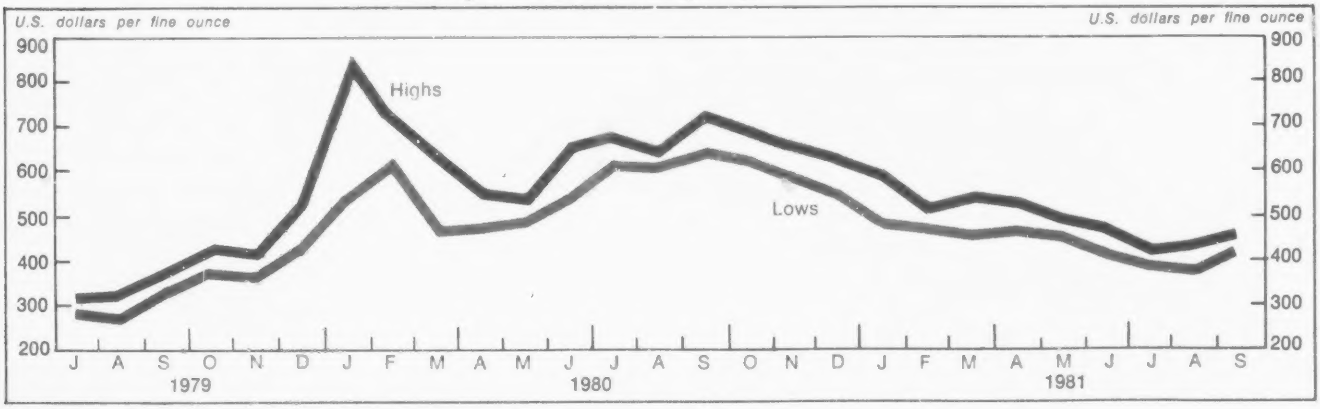
Gold Price

London
afternoon fixing

445.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Gold prices: monthly highs and lows*



* London afternoon fixing

Updating the Gold Market

Gold prices appear to have firmed up in recent weeks after dipping below $400 an ounce in August, and traders are hopeful that the long bear market (see chart, page 6) has finally run its course. Appearances, however, can be deceiving, and a further price plunge cannot be ruled out. To be sure, the fundamental balance between new supplies and expected demand suggests long-term strength in gold prices. However, the fundamentals can easily be swamped—as they have been throughout much of the past two years—by world economic and political developments.

Gold specialists generally agree that supplies of newly mined gold will remain tight over the next decade. Production in South Africa, which supplies about three-fourths of the gold mined in the non-Communist countries, peaked in 1970 at around 1,000 metric tons and has been sliding ever since. It fell to 675 tons last year from 703 tons in 1979, as mining companies turned increasingly to areas of lower-grade ore. Despite efforts to improve productivity and develop new technology, South African gold production is not likely to rise much above current levels during the 1980s, even if prices move substantially higher. And in the absence of major new discoveries, mine output in other parts of the world cannot pick up the slack.

Other traditional sources of new gold supplies to the private sector will also be limited in the near term. According to Consolidated Gold Fields Ltd. of Britain, net sales from Communist countries fell to 90 tons in 1980, the lowest level since 1971. Predictions for 1981 Soviet gold sales range from 80 to 130 tons, far below the average for the 1970s. Moreover, there has been a sharp reversal in the trading patterns of governments and central banks, which were large net suppliers of gold to private markets throughout most of the 1970s. Central banks, especially in the less-developed countries (LDCs), have become large purchasers of gold. Official institutions were net buyers of 230 tons in 1980—a pattern that is likely to continue.

On the demand side, total fabrication from new gold supplies fell sharply in 1980 and has not picked up materially in 1981. The increase in private holdings of carat jewelry rose only by 120 tons last year—substantially below recent trends. Part of this fall-off can be attributed to one-shot "dishoarding" in the form of melted jewelry, especially in the LDCs, as prices soared to record highs. But long-term demand for fabricated gold for such applications as electronics and dentistry is also diminishing, as advances in technology permit substitution of lower-cost metals and reduction of gold content per unit.

Nevertheless, overall demand is likely to strengthen. Speakers at the Amcon Group's 1981 gold seminar in late September said they expect the gold market to be buoyed in the 1980s by the re-entry of portfolio investors and large institutions, whose demand has been weak over the past two years. The massive dishoarding and inventory liquidation of 1980-81 appear to be over, and gold-price optimists are counting on a strong boost from U.S. and Japanese investors, along with continuing heavy demand from LDC central banks. Political attention to a restoration of the gold standard should also help to strengthen prices. And of course, another sharp upsurge of inflation or political instability could spark a massive reflow of investment funds back into gold.

The big imponderable in the gold equation, however, is the sizable overhang of "above-ground" gold stocks, estimated at about 90,000 tons, or almost a century's worth of Western gold production at current mining rates. About half of this overhang is thought to be in private hands, and much of it remains poised to flood the market and drive gold prices down if clear signs emerge that U.S. anti-inflation efforts are succeeding and that the world political scene will remain reasonably stable.

Ronald A. Krieger

GOLD FLOWS

Components of Supply (metric tons)

	Non-Communist mine output	Net trade with Communist bloc	Net official sales (purchases)	Total
1971	1,236	54	96	**1,386**
1972	1,182	213	(151)	**1,244**
1973	1,117	275	6	**1,398**
1974	1,006	220	20	**1,246**
1975	954	149	9	**1,112**
1976	970	412	58	**1,440**
1977	972	401	269	**1,642**
1978	979	410	362	**1,751**
1979	961	199	544	**1,704**
1980	943	90	(230)	**803**

Components of Demand (metric tons)

	Total fabrication			Net private bullion purchases (sales)	Total
	Carat jewelry	Official coins	Other		
1971	1,064	54	269	(1)	**1,386**
1972	999	63	282	(100)	**1,244**
1973	518	54	287	539	**1,398**
1974	225	287	223	511	**1,246**
1975	523	251	209	129	**1,112**
1976	935	182	266	57	**1,440**
1977	1,003	142	274	223	**1,642**
1978	1,007	288	301	155	**1,751**
1979	737	290	288	389	**1,704**
1980	120	234	167	282	**803**

Data: Consolidated Gold Fields Ltd.

Ivory Coast Pursuing Balanced Growth

The pace of economic growth continues to slow in Africa's Ivory Coast, while the country's current-account deficit widens and external debt grows more onerous. But the prospect of self-sufficiency in oil output by 1985, conservative economic management, and a liberal foreign investment code are attracting strong capital inflows and promise a reacceleration of economic growth beginning in 1982.

The Ivory Coast's $10.5-billion economy has suffered the sharp terms-of-trade deterioration common to most of the world's agrarian-based developing countries over the past 2-3 years. As an important world producer of coffee, cocoa, and timber, the country enjoyed an average annual real GDP growth of 8.9% during the 1976-78 world coffee and cocoa boom, with manageable deficits on current account. Growth subsequently slowed to 5.2% in 1979, owing largely to depressed world commodity export markets, and the current-account deficit widened substantially.

Ivorian export prices continued weak in 1980, with average coffee and cocoa bean prices down 11% and 20%, respectively, from their 1979 levels. Industrial growth, which since independence in 1960 has been steady (so that industry's 22% contribution to GDP now almost equals that of agriculture), also appears to have slowed because of cutbacks in public investment that reflect a broadly restrictive fiscal stance. And although crude oil production from offshore deposits began on a modest scale in August 1980, with a major expansion of refining capacity under way, inflation-adjusted GDP growth is believed to have slowed further last year.

The Ivory Coast's economy found itself in severe financial difficulty at the end of 1980, owing to a significant terms-of-trade worsening and a liquidity squeeze in the second half of the year. As a result, the International Monetary Fund on March 3, 1981, approved a three-year Extended Fund Facility loan of $630 million to support economic and financial stabilization. The conditions attached to the loan are relatively mild, in recognition of the Ivorian government's sustained budgetary austerity (restrictive budgets were adopted in 1979 and in 1980 under a previous IMF-sponsored program) and the country's oil potential. And the retrenchment course chosen attests to the authorities' preference for putting the domestic economy in order rather than borrowing further in anticipation of oil revenues.

If the terms of the latest IMF program are implemented fully, the Ivorian budget deficit would be cut to 6.2% of GDP by 1983 (from 15.2% in 1980) and the current-account balance-of-payments deficit halved. The program places special importance on boosting the productivity of investment, with the goal of redirecting industrial investment from import substitution to export-oriented activity. In pursuit of this goal, the authorities are expected to liberalize further the Ivory Coast's already liberal foreign investment code. The stabilization plan is also aimed at boosting domestic private savings and utilizing them more productively.

Finally, the IMF-sponsored program underscores the Ivory Coast's long-standing priority of diversifying agricultural exports by further encouraging new crops. Agricultural policy has consistently stressed the introduction of new crops to lessen the vulnerability of exports to price fluctuations and to limit food imports in the face of rapid population growth. Still, coffee and cocoa accounted for about 56% of total exports in 1980.

Economic performance in 1981

Not surprisingly, the economy has remained sluggish this year. The combination of reduced government spending, continued export price weakness, and liquidity tightness point to a sharp slowdown in the rate of real economic growth in 1981, with the possibility of a contraction. The recession, which is essentially investment-led, is mainly affecting the urban sector. Agriculture is being buoyed by record coffee and cocoa crops.

On the external front, a projected improvement in the trade surplus, the result of a progressive rise in oil production and higher export volume, will be offset by higher invisibles payments. Services outflows are high because of interest payments on a disbursed foreign debt of nearly $4 billion (40% of GDP) and heavy outward remittances of foreign workers. As a result, the current-account deficit is likely to widen to about $1.7 billion from $1.5 billion in 1980. The overall payments deficit could narrow this year, however, in anticipation of increased capital inflows.

The oil bill, which reached some $500 million last year, is expected to fall to $400 million in 1981 and to decline steadily as domestic production increases. It is projected that the Ivory Coast will become a net oil exporter in 1983, with oil output by 1985 forecast to reach 220,000 barrels per day. While oil export receipts will reduce the Ivory Coast's external deficits, a current-account surplus is unlikely before 1985-86, on the assumption of sustained cocoa and coffee price weakness.

In sum, the pace of real GDP growth is expected to bottom out in 1981, with the start-up of oil production pointing to a reacceleration in growth in 1982, and a possible mini oil boom thereafter. The promising outlook for petroleum exports and the IMF-fostered economic austerity suggest improvements in the Ivory Coast's large current-account deficits and high external debt burden. And the country's progress on the agricultural, industrial, and energy fronts promise balanced growth as the decade unfolds. *Wally V. Koch*

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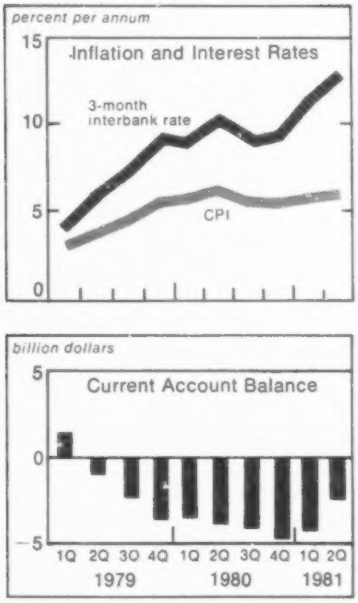
Caution the Keynote Of German Monetary Policy

The recent rise in the German mark against the world's major currencies and the subsequent one-point reduction in Germany's Lombard rate have once again focused attention on the policy trade-offs facing Germany's central bank. Last February, the Bundesbank raised interest rates despite the domestic recession, ostensibly to protect a rapidly declining German mark. The Bundesbank felt, quite justifiably, that further declines in the DM would create inflationary pressures that might trigger a wage-price spiral. The real costs of having eventually to control such a spiral outweighed the costs of immediate action on interest rates.

The February measures were partly successful. Although they failed to prevent a further decline in the DM against the U.S. dollar, they helped prevent higher import costs from spreading through the economy. As a result, Germany's international competitiveness improved by some 8% and its trade balance, in volume terms, recovered dramatically. The chief reason for the DM's original weakness—a $14-billion current-account deficit in 1980—now looks set to reverse itself. Indeed, a somewhat stronger DM will bring positive price effects that may make official predictions of a $6-billion current-account deficit for 1982 too pessimistic.

German economic indicators



The projected turnaround in Germany's current account, combined with a (still relatively low) 6.5% annual inflation rate, is leading to something of a reassessment of the German currency. A shift of international portfolio preferences in favor of the mark may present the Bundesbank with a new set of choices. The first is reducing German interest rates relative to those overseas (mainly in the United States). The second is holding interest rates constant relative to those abroad, allowing the DM to appreciate further.

The Bundesbank's choice will ultimately involve two judgments: the degree of inflationary pressure now in the economy, and the course of U.S. interest rates. A continued restrictive policy would reduce DM-denominated import prices, which have risen by some 20% over the past year, and probably stiffen employer resolve in the forthcoming wage round. It would, however, further weaken an already sluggish domestic economy. On the other hand, a rapid reduction in rates, which would stimulate domestic demand, would risk internalizing imported inflation and prove counterproductive if the current decline in dollar interest rates proves temporary. The German central bank is therefore likely to adopt a cautious attitude in the short run. Should a consolidation of trends favorable to the DM materialize, particularly after this winter's wage round, a more rapid relaxation of policy would then ensue.

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Export-dependent Austria looks to Europe for recovery.

Despite a mild recovery in the second half of this year, Austria's economy is expected to show no growth for 1981 as a whole. The inflation rate of just under 7% has eroded disposable incomes, keeping private consumption flat. At the same time, a low rate of capacity utilization and high real interest rates have held back investment spending. Nonetheless, despite what promises to be a mildly restrictive budget, most observers expect a gentle recovery in 1982, with real GDP growth of 2%-3%. The key elements are a hoped-for reduction in the rate of inflation, which should boost real incomes and consumer spending, and faster export growth based on a decline in the real trade-weighted value of the Austrian schilling. A major uncertainty for this export-dependent economy, however, remains the extent of European recovery. If that recovery is delayed by continuing tight monetary conditions, Austria's exports and its overall economic performance would fall short of current expectations.

Israel's economic difficulties are broad-based.

The consequences of economic measures implemented prior to the June elections in Israel are now being felt. Reversing his predecessor's policy, Finance Minister Yoram Aridor slashed indirect taxes and reduced subsidies on many consumer goods. These measures achieved some success in curbing short-term inflationary pressures. In the May-July period, consumer prices advanced at a 61% year-over-year rate, compared with a 133% leap in prices over the course of 1980. The initiatives spurred purchases of consumer durable items, and demand was largely met through a rise in import volume. In addition, the budget deficit widened further and was accommodated through monetary growth. These developments cast doubt on the strength of Israel's future economic performance and have led to some policy revision. Spending plans are being curtailed and subsidies have been cut once again. As a result, the hike in the cost of living in September was 8.1%, bringing the year-over-year inflation rate to 98%. Growth forecasts are now being revised downward, with GNP likely to register only a 2% increase this year following 2.3% in 1980. The external-account outlook is similarly bearish. Israel's current-account deficit may widen to more than $1 billion this year from $880 million in 1980.

Iceland outlook buoyed by energy resources, but high inflation persists.

Although Iceland possesses abundant geothermal energy, it still must import oil for transportation purposes and for its fishing fleet. A new agreement with the USSR ensures that the Soviets will supply all of Iceland's requirements for this year and next, but longer-term plans call for further exploitation of the country's geothermal energy resources. Latest forecasts suggests a 50% increase in energy consumption by 1990, but also allow for an increase in the share of renewable energy sources to 77%. In 1980, 72% of the population had geothermal space heating, and by 1985 the figure should reach 80%. By contrast, the percentage of the population utilizing oil heat is expected to fall from 13% last year to 2% in 1985. Such growing energy independence enhances Iceland's potential for strong economic growth in the future. Indeed, the signs are that, after this year's stagnation, real GDP growth will move toward the 1976-80 average of 3.7%, while the country's debt service ratio should fall from this year's record 15%. The dark cloud over the economy, however, remains a high inflation rate, which, while untamed, will continue to dampen growth. Despite some recent slackening in inflation, prices in 1981 will be about 50% higher than in 1980. This compares with a 58% figure last year and with an average inflation rate of 42% over the last five years.

Dominican Republic policy austerity dampening growth.

The Dominican Republic's international payments position continues weak. The causes stem from overstimulative demand-management policies undertaken from 1979 through mid-1980 and terms-of-trade deterioration. The country's deficit on current account more than doubled to $715 million in 1980 from an average of $340 million in 1978 and 1979, and commercial payments arrears have accumulated rapidly. To check these imbalances, the authorities have since mid-1980 pursued tighter fiscal and monetary policies. These policies have virtually eliminated the central government's budget deficit this year from a level equivalent to 6% of GDP in 1979, while monetary growth has been cut to 1% from 16% in 1979. At the same time, import payments have been increasingly channeled to the parallel foreign-exchange market—effectively constituting a partial exchange-rate correction—and greater import restrictions have been imposed. While the adjustment program should narrow the 1981 current-account deficit to some $650 million, it is expected to dampen economic activity and reduce price pressures. Real GDP is thus expected to grow by 3%-3.5% this year, down from an average of 5% in 1979 and in 1980. And the country's annual average inflation rate is expected to be about 8% in 1981, compared with 13% in the previous two years.

Japan moving decisively to cut public deficit.

In striking similarity to the current U.S. strategy, Japan's government is attempting to slash spending to ease its burgeoning national debt. The government, whose debt is expected to reach 82 trillion yen ($390 billion) by the end of March 1982, will have to finance 26.2% of its fiscal 1981 spending through bond issues, compared with only 6.5% in the United States and 12% in Germany. The Suzuki government has pledged to reduce this level to zero by the end of fiscal 1984. To lower its bond issue by 1.8 trillion yen in the next fiscal year without raising taxes, the government has instructed most departments to hold their spending requests to this year's level. About the only increased allocations allowed in the draft budget are a 7.5% rise in defense spending and an 11.4% increase in foreign aid. The Suzuki government has also presented parliament with an administrative reform proposal designed to trim government spending on various social programs. Although most of these spending cuts are expected to be enacted, the "guns-versus-butter" debate could be heated and might ultimately result in a smaller rise in defense spending.

Pakistan applies Islamic principals to financial sector.

Of all Islamic nations, Pakistan has so far gone the furthest in applying Islamic principles to its financial sector. In accordance with the Koran, the government has sought to replace the payment of interest with markups or equity participation plans that reward investors with a share of profits and losses. Since January 1, 1981, domestic banks have been required to offer, along with conventional interest-bearing accounts, new zero-interest savings accounts known as Profit-Loss Sharing (PLS) deposits for investment in profit-sharing ventures. Profits or losses earned from these ventures are distributed among depositors on a pro-rata basis after deductions are made for normal banking expenses. As of July, such PLS deposits constituted about 4.5% of Pakistan's total bank deposits. Their yields during the first six months of 1981 ranged from 8.5%-15.25%, depending on maturity, compared with returns of 7.5%-12% on conventional, interest-bearing accounts. Despite these attractive returns, there is still great uncertainty as to how the interest-free system will evolve. And it is feared that this uncertainty will depress Pakistan's already-low domestic savings rate.

South African external accounts deteriorating.

South Africa's trade balance has worsened steadily over the course of 1981. For the first eight months of the year, the country registered a $300-million deficit, in sharp contrast to a $5.4-billion surplus for the same period last year (after adjustment for a 6% depreciation of the rand vis-à-vis the U.S. dollar). Total exports fell 18% to $13.9 billion, and imports rose 23% to $14.2 billion. Sales to the United States—since 1978 South Africa's main trading partner—fell 11% to $1.5 billion, largely reflecting reduced South African sales of Krugerrands, platinum, and diamonds. Imports from the United States, however, increased 38% to $2.3 billion, spurred by relaxed U.S. export restrictions under the Reagan administration on the sale of such products as medical equipment and pharmaceuticals, as well as computer equipment, to the military. Assuming some strengthening of gold prices in the remaining months of 1981, the trade account is likely to end the year in rough balance, after a $7-billion surplus last year. This suggests a similar swing in the current-account balance to a deficit of about $3.5 billion.

Consolidation in the Business Sector

Speculation of a "merger mania" earlier this year was fed by the large number of companies that had lined up huge loan commitments either to acquire other companies or resist takeover. Many market analysts feared bidding wars would lead to a credit crunch and soaring interest rates as the credit lines obtained were drawn down. These fears have not yet been realized. But a weakening economy, high interest rates, and reduced credit availability may have led to a different form of consolidation in the business sector—bankruptcies. Mergers may therefore be the more desirable response to present economic conditions.

Business failures have increased dramatically since early 1980. According to Dun and Bradstreet, the failure rate per 10,000 businesses averaged slightly less than 29 during the expansion years of 1976-79. But as the economy nosedived in the second quarter of 1980, the failure rate jumped to 46. The first nine months of 1981 saw a further 40% surge in bankruptcies, which propelled the failure rate to nearly 60.

Although the doubling of the failure rate during the last two years (compared with the previous four-year period) appears worrisome, the recent level of bankruptcies is not high by historical standards. Between 1950 and 1965, for example, the failure rate averaged nearly 50, and from 1880 through 1933, it approximated 100. Nonetheless, the rise in bankruptcies has elicited more vocal protests over high interest rates.

The role of interest rates in increasing the number of bankruptcies, however, is not as obvious or important as some critics of Federal Reserve policy suggest. Money, or credit, is only one input to the production process (although one whose importance increases in a highly inflationary environment). Restraint of money-supply growth by the Fed has raised the cost of credit—at least in the short run—and has put upward pressure on prices. Business firms do have recourse, however. They can either pass through higher credit costs or economize on the use of credit.

With the contraction of the economy in the second and third quarters of 1981, and further prospective declines in real output seen well into 1982, many firms are finding it difficult to pass on increased borrowing costs in the form of higher prices. Moreover, creditors are increasingly concerned about business' outstanding debt levels. Consequently, the desired level of inventories is expected to shrink, some capital projects will be stretched out or cancelled, and further cash-management innovations will be sought to conserve money and credit. In the short run, limits to such conservation measures are expected to keep the failure rate high—and possibly rising. To the extent that mergers enhance efficiency, or improve the access of the enlarged firms to credit, they are a sound response.

Bailout or Deregulation

Treasury Secretary Regan's testimony last week before the Senate Banking Committee provides added insight into the dilemma of current bank regulation policies. In the first place, as Mr. Regan noted, the range of difficult policy questions is extraordinarily wide. They include deposit and loan-rate ceilings, increased operating powers, mergers, geographic expansion, and financial assistance for ailing institutions.

In the second place, there are conflicts between the near-term objectives of regulatory policy and the longer-term goal of fostering greater competition in financial markets. In the short run, there seems to be a pronounced emphasis within government circles on defense. This is aimed chiefly at the weakened thrift industry, some elements of which are under considerably more duress than others. All-savers accounts, for example, were established as a means of lowering the costs of acquiring deposits. Also being considered is liberalizing the terms under which deposit insurance agencies may advance funds to severely pressed institutions. A major constraint on the latter, however, is the potential for large increases in federal spending and borrowing. The process of deregulation itself is further strained because of pressures from thrifts and others for insulation from market forces. The rollback of the ½-point rise in savings deposit ceilings and strong opposition to other forms of ceiling relaxation are foremost examples.

From a longer-term perspective, regulators are faced with a situation in which restrictive regulation and sharply declining transactions costs are rapidly stimulating a more active role in financial services by non-deposit entities. This in turn is eroding the role played by banks and thrifts in loan and deposit markets. Secretary Regan's support for such liberalized powers as expanded non-consumer banking functions (for thrifts) and certain investment banking activities (for banks) points to a greater eventual convergence of service capabilities among participants in financial markets.

How to get from the short-run protection atmosphere to one of enhancing greater competition is frustrating legislators and practitioners alike. Secretary Regan touched on one element regarded by many as a central vehicle for at least part of this transition—interindustry and interstate mergers and acquisitions. Various forms of combinations, not only among banks and thrifts but among securities and insurance firms as well, would provide greater institutional strength and, of course, stimulate functional convergence.

In the past, crisis environments often tended to generate more, not less, protection and regulation. There may be cause for some optimism this time around, however. The speed with which the "unregulated" financial-service entities have expanded their positions is clear testimony to the punishing effects of regulatory burdens on depository institutions. Those designing regulatory changes can hardly ignore this reality.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
												12-month changes				exchange rate in U.S. dollars	change from year earlier		
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	October 21, 1981		current monetary conditions	
Argentina	Economy in recession, with industrial sector operating at 50% of capacity.	June	+ 46%	117.0	$4,333	June	3,818	— 53%	4.7	0	Export gains spur rise in reserves.	Sept.	+ 119%	July	+ 67%	.000125	— 80%	Interest rates decline as demand falls.	Argentina
Barbados	Exports and tourism fall off as result of weak U.S. and European economies.	May	— 1%	0.8	3,055	Aug.	56	— 23%	1.2	2	Reserves down $30 million since April.	July	+ 14%	June	+ 16%	.5200	+ 5%	Central bank and commercial interest rates increase.	Barbados
Bolivia	New mining law allows free external marketing, permits state companies to set up joint ventures.	June	— 7%	6.1	1,100	Aug.	80	— 49%	1.2	71	Total debt is $3.7 billion, with reserves negligible.	June	+ 27%	June	— 2%	.0425	+ 4%	Net foreign assets down.	Bolivia
Brazil	Inflation rate continues to fall; industrial sector in recession.	Aug.	+ 18%	237.2	1,991	Aug.	5,438	— 7%	2.7	0	Trade shifts into surplus as imports lag.	Sept.	+ 110%	June	+ 57%	.0092	— 47%	Availability of cruzeiro credit limited.	Brazil
Chile	Banking laws revamped to break up trusts and stave off financial-market disruption.	July	— 15%	22.8	2,060	Aug.	3,406	+ 21%	5.7	65	Current-account deficit in 1981 likely to be more than double 1980.	Aug.	+ 18%	June	+ 29%	.0265	— 2%	Real interest rates higher than at end-1980.	Chile
Colombia	Important new oil discovery and rising output brighten petroleum prospects.	Apr.	— 31%	36.8	1,360	Aug.	4,454	+ 2%	10.5	0	Trade deficit reemerges as coffee earnings drop.	July	+ 29%	Feb.	+ 26%	.0200	— 13%	Private credit conditions restrictive.	Colombia
Costa Rica	Rescheduling of $2.6-billion public external debt now under way.	May	— 6%	4.6	2,063	Aug.	149	+ 53%	1.3	104	Foreign-exchange gap of $1.25 billion seen thru 1982—25% of 1980 GDP.	May	+ 30%	Apr.	+ 37%	.0600	— 50%	Liquidity is tight.	Costa Rica
Dominican Rep.	Tight fiscal and monetary stance slowing 1981 GDP growth to about 3%-3.5%.	June	+ 39%	6.9	1,280	Aug.	205	— 3%	1.5	29	Trade gap expected to be halved in 1981 from $500 million in 1980.	May	+ 8%	June	+ 1%	Par	—	Interest rates raised 1% to maximum of 8.5%.	Dominican Rep.
Ecuador	Larger government deficit prompts drive for increased revenues and spending cuts.	Aug.	— 1%	11.0	1,321	July	704	— 17%	3.8	0	Government providing some support of exchange rate.	July	+ 16%	Apr.	+ 34%	.0345	— 10%	Bank liquidity under pressure.	Ecuador
Guatemala	Economic deterioration continues in light of political turmoil.	Dec.	+ 1%	7.9	1,090	Aug.	257	— 54%	2.1	0	Foreign currency restrictions tightened to check capital flight.	Apr.	+ 13%	June	— 2%	Par	—	Money supply contracting.	Guatemala
Mexico	Upward revision of official GDP statistics show rapid 8.5% growth in 1978-80.	Apr.	+ 54%	167.0	2,300	Mar.	3,084	+ 39%	1.6	0	Current-account deficit expanded by 78% in first-half 1981.	Sept.	+ 28%	May	+ 41%	.0400	— 8%	Fiscal pressures speed money supply growth.	Mexico
Nicaragua	State emergency declared, with bans on strikes, import tax hikes, and public spending cuts.	Dec.	— 22%	1.9	730	Nov. '79	85	+ 42%	4.5	25	Agreement on restructuring $180-million in debt owed by nationalized banks.	Dec.	+ 27%	Aug.	+ 90%	.1000	1%	Credit conditions restrictive.	Nicaragua
Panama	More efficient operation of state-owned sugar and cement firms improve earnings.	May	+ 29%	3.5	1,805	July	101	+ 23%	0.8	97	Export earnings boosted by high shrimp prices.	June	+ 7%	May	+ 14%	Par	—	Credit to public sector declines.	Panama
Paraguay	Strong increase in official export earnings through June 1981 attributed to timber, cotton, soybeans.	June	+ 15%	4.6	1,505	Aug.	785	+ 7%	16.3	0	Pressures on free exchange rate emerging.	Apr.	+ 16%	June	+ 17%	.0080	0	Domestic credit is scarce.	Paraguay
Peru	Fiscal budget deficit expanding sharply.	July	— 17%	17.0	955	Feb.	1,756	+ 26%	7.5	393	Widening current-account gap leads authorities to boost foreign loan ceiling.	Sept.	+ 72%	June	+ 47%	.00225	— 42%	Net foreign assets declining.	Peru
Trinidad	Manufacturing output hampered by labor, electricity, and water-supply problems.	Apr.	+ 10%	5.4	4,780	Aug.	3,038	+ 28%	13.2	0	Higher oil export prices offset volume drop.	May	+ 15%	May	+ 24%	.4300	+ 5%	Bank deposit growth slows down.	Trinidad
Uruguay	Government eliminates exchange-rate guarantee enacted in March to boost confidence in peso.	May	+ 64%	9.8	3,379	June	633	+ 35%	4.7	0	Wheat expected to be exported for first time since 1976-77.	July	+ 32%	Dec.	+ 52%	.0920	— 11%	Interest rates far higher than international rates.	Uruguay
Venezuela	Social spending to have priority in 1981-85 development plan.	May	+ 24%	51.4	3,690	Aug.	8,060	— 1%	8.8	0	State entities may now secure medium-term Euroloans.	July	+ 17%	Mar.	+ 15%	.2330	0	Interest rates liberalized.	Venezuela

World Interest Rates

market rates of Oct. 21, 1981; bond yields as of Oct. 16, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 16.00	18.31	15.50	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	7.25
Day-to-Day Money	15.50 Oct. 22	19.50	15.50	10.95	16.75	11.00	20.125	12.875	8.50	7.4375
Treasury Bills 91-day, Middle Rates	13.22 discount basis	18.05	15.437	15.75	n. a.	n. a.	19.00 86 day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	14.375 finance paper discount basis	19.00 finance paper 15% tax w/h	14.26	12.90 Certified	16.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.75	18.80 15% tax w/h	15.437	12.90 Certified	not traded	9.90	23.90	no market	11.00	no market
Government Bonds Long-term, new and old issues, average yield	15.00	17.20	15.58	10.016 20% tax w/h	16.39	10.12	20.67	11.94	6.00	8.41
Industrial Bonds prime, long-term, new and old issues, average yield	15.85 Aa Industrials	18.125	16.75	19.691	17.89	10.15	20.49	13.06	6.9125	7.18
Bank Short-Term Rate to Best Borrowers (prime rate)	18.00	20.00	16.50	18.00	19.50	14.50	22.50 ⅛ quar'ly fee on outstdng.	14.50	10.50	6.75
Bank Time Deposits 3-month	15.25 Cert. of Dep.	16.375	16.187	15.20	16.125	11.30	10.75	12.875 large deposits	9.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	16.50	no market	16.5623	no market	17.50	11.4375	no market	12.8125	11.125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8304	1.8140	.0262	.1750	.4387	.00083	.3984	.5265	.00427
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.00 *D*	0.30 *P*	2.00 *D*	1.00 *D*	5.00 *P*	6.00 *D*	3.00 *P*	5.00 *P*	9.00 *P*

Eurodollar Deposits

(London, interbank, bid)
October 22

7-day	15.8125
1-month	16.00
3-month	16.4375
6-month	16.75

International Arbitrage

(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.705
U.S.-Canada Treasury Bills	−1.818
U.S.-Canada Finance Co. Paper	−2.364
Eurodollars-U.K. Local Auth. Deposits	−0.2375

Eurobonds

(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	16.875
Over 7 yrs.	16.562
DM Bonds	
7 yrs. and under	10.75
Over 7 yrs.	10.50

Gold Price

London afternoon fixing

429.00

(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	10.9 (Aug.)	12.5 (Sept.)	11.4 (Sept.)	13.6 (Aug.)	6.6 (Sept.)	18.3 (Sept.)	7.5 (Sept.)	4.1 (Aug.)
Industrial production*	−0.8 (Sept.)	4.6 (July)	−3.5 (Aug.)	−5.9 (Aug.)	0.9 (Aug.)	−3.0 (Aug.)	−2.6 (Mar.)	5.2 (Aug.)
Trade balance† *(billions of local currency units)*	−$5.61 (Aug.)	C$0.36 (Aug.)	£0.01 (Sept.)	−FF8.46 (Sept.)	−DM0.06 (Aug.)	−Lit.1,040 (Aug.)	−SF0.94 (Sept.)	¥407 (Aug.)
Money supply (M1)*	4.9 (Sept.)	4.0 (Aug.)	12.6 (June)	12.1 (May)	1.4 (July)	11.9 (April)	−2.4 (June)	4.6 (June)
Velocity of money (M1)*	12.9 (Mar.)	−0.14 (Dec.)	9.8 (Dec.)	n. a.	0.7 (Mar.)	4.6 (Mar.)	n. a.	13.0 (Mar.)
Reserves minus gold *($ million, change from previous month)*	400 (Aug.)	983 (Aug.)	30 (Aug.)	−603 (July)	−1.463 (Aug.)	732 (Aug.)	−210 (Aug.)	144 (Aug.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Policy Constraints Limit Swedish Growth

Sweden's economic performance in recent years has been weak, even by European standards. Its major problems stem from insufficient adjustment to high energy prices and to a world in which competition for export markets has become intense. These difficulties in turn result largely from the economy's socialist orientation and a political environment in which corrective economic policies are sometimes difficult to implement. Nonetheless, Sweden's possession of the fourth highest GDP per capita in the industrialized world (nearly $15,000) allows it sufficient flexibility to adjust to the new economic realities.

Insufficient economic adjustment

Sweden's adjustment to higher energy prices has been blocked primarily by resistance to downward wage adjustment. The run-up in energy prices necessitates that the average level of real wages and of real profits be reduced to maintain full employment—a high priority for Sweden. It also requires that resources be transferred toward less energy-intensive processes and that substitution and conservation efforts be stepped up.

Substantive progress has been made on the energy conservation and substitution fronts. The Swedish authorities have imposed tax increases to reduce consumption of oil products and are aiming to cut oil imports from the current 26 million tons annually to between 14 and 17 million tons per year by 1990. Furthermore, plans have been formulated to replace oil imports with imported coal and with peat from forests. Significantly, however, Sweden's strong labor unions have resisted cuts in real wages. This has contributed to a fall in profits and in investment, and also to a rise in rates of unemployment and inflation.

Gross fixed investment in real terms grew only slightly in 1980 and is expected to decline by some 8% this year. And although still low, Sweden's unemployment rate is expected to average 2.3% in 1981, up from 2% last year. The rate of consumer price rise, which surged to 13.7% last year from 7% in 1979, is forecast to remain at about 13% this year. Also dampening business conditions is the government's large and growing budget deficit, which is forecast to widen to 11.2% of GDP in 1981. Rapid increases in public spending in the early 1970s gave a large boost to the deficit, which has expanded further in recent years because of a recession that has cut revenues and increased welfare-related expenditures (see table).

The vital export sector has also lost momentum. With recession worldwide crimping export demand, certain export industries are facing stiff competition—especially from the newly industrialized countries—and it is questionable whether they will regain their former market position. Adjustment to the loss of competitiveness in some industries requires flexibility across industries and internal resource mobility, but the Swedish system does not encourage these traits. High marginal rates of taxation dampen entrepreneurial initiative and innovation, while the geographic mobility of labor is discouraged by job-protection schemes and by existing arrangements for providing low-cost housing. Reflecting these obstacles, export growth has waned. Merchandise exports are projected to decline by 5% this year after 12% growth in 1980. However, with import demand down and a reduced services deficit, Sweden's trade and current-account deficits are expected to narrow significantly this year (see below). Moreover, Sweden's large supply of international reserves—$3.6 billion, excluding gold, at the end of August—and continued healthy capital inflows make deficit-financing no problem. And although Sweden is a debtor nation, with a net foreign debt of about $10 billion at the start of 1981, the ratio of debt to a GDP of $123 billion last year was only 8%, and the country possesses substantial overseas assets.

Domestic Indicators

	1979	1980	1981 est.
Real GDP Growth, %	3.9	1.4	-1.0
Inflation Rate, %	7.0	13.7	13.0
Money Supply (M3) Growth, %	16.5	12.3	9.5
Central Government Borrowing Requirement, *% of GDP*	9.6	10.5	11.2

Current Account Balance

(billion $)

	1979	1980	1981 est.
Imports, *c.i.f.*	28.7	33.5	29.5
Exports, *f.o.b.*	27.5	30.9	29.3
Trade Balance	-1.2	-2.6	-0.2
Current Account Balance	-2.7	-5.2	-3.2
Reserves/Average Monthly Imports	1.72	1.18	1.39

Compromises limit policy effectiveness

The political environment in Sweden is such that no party commands an overall majority. Consequently, coalition governments are the norm. And the Swedes generally seek complete consensus on policy initiatives,

Policy Constraints Limit Swedish Growth

(continued from page 7)

respecting the wishes of minorities. These features preclude the adoption of potentially divisive policies, even if favored by the majority. It is thus no surprise that the recent performance of the Swedish economy reflects short-term measures introduced by the government, rather than a coherent, long-term economic policy.

Already this year, a series of short-term policy responses to economic pressures have occurred. Sweden began 1981 with a relatively high, but slowing, rate of economic growth and with an expanding current-account deficit. Despite public spending cuts announced in October 1980, the budget deficit was expected to widen to more than 60 billion kronor ($11.5 billion). Wages were rising faster than in many other industrialized countries, and international competitiveness was declining.

This gloomy scenario triggered a run on the krona in January 1981, which the government countered with higher interest rates. The country's prospects improved still further in February with a two-year wage settlement that provided for wage increases of about 7.1% over two years. Spillover effects and increased employers' contributions, however, meant that the increase in labor costs in 1981 would be approximately 9.5%, while those in 1982 would be about 6%. In addition, the agreement contained a provision for indexation whereby wages would climb still higher if prices rose by more than a specified amount.

The end of April saw a crystallization of the political constraints. The coalition of non-socialist parties disagreed over taxation policies, and the prime minister resigned—only to form a new coalition government immediately afterward. It was clear, however, that the new government would be no more able to introduce strong policies than the old, and that no new initiatives could be expected before the next election—scheduled for September 1982.

By September, the strength of the U.S. dollar was causing considerable problems for Sweden's economy. With the krona stabilized against a basket of currencies, its depreciation against the dollar had to be matched by an appreciation against such other currencies as Germany's mark, even though costs in these countries were rising more slowly than in Sweden. Swedish exporters thus found themselves increasingly unable to compete, and on September 14 the authorities announced a 10% devaluation.

Theoretically, the devaluation would have led to higher prices, and would have thereby—assuming money wages stood unchanged—provided a means of reducing Sweden's high level of real wages. But since wage indexation formulas would have raised wages in line with prices (which would be bid up because of the devaluation's impact on import costs), the government was forced into a policy compromise. It announced a price freeze for the remainder of 1981, together with a reduction in value added (sales) taxes to hold rises in the price index below the trigger point. Thus, one problem was dealt with at the expense of another. Meanwhile, the price freeze will hinder a restoration of profits and a consequent increase in investment, while the value added tax reduction will cut into the government's tax revenues and further widen the budget deficit.

Implications for growth in 1981-82

The net result of these policy maneuverings and economic influences will be negative real GDP growth of an estimated 1% in 1981, with large declines in private consumption and investment. Domestic business activity will be hurt by rising input costs matched by restrictions on price increases, which will squeeze profit margins. And although the central bank has cut its discount rate to 11% from 12% (the first rate reduction since 1978) to spur investment and ease inflation, the large government deficit is expected to keep interest rates high and credit conditions tight.

The export weakness seen this year may reverse itself slightly in response to the September devaluation, but not sufficiently to prevent a decline in the value of merchandise exports for the year. It appears that only the public sector will show any real buoyancy this year—at the cost of a growing deficit.

Prospects for 1982 are only slightly brighter. The government is likely to introduce a reflationary package in time for the September elections. In the absence of a stimulative package of measures next year, however, private consumption and investment could fall by an additional 1%, owing largely to the continuation of an unfavorable business climate. In any event, public consumption and investment are each scheduled to grow by 1.5%. The stimulus of government spending, together with a forecast 3% growth in exports, should prevent GDP from falling again in 1982, keeping it at about its 1981 level.

In sum, although Sweden's current and prospective economic position is bearish, the country has demonstrated an ability to resolve its difficulties in the past. If it succeeds in forging the necessary political consensus to implement long-term corrective economic policies—possibly after the 1982 elections—it can lift its economy out of the doldrums. While corrective policies will entail sacrifices, a short-term reduction in living standards would not be likely to have serious consequences in a country with one of the highest per capita GDPs in the industrialized world.

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